



European University Institute
Department of Law

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The Group of Companies, Efficiency and the Law

Supervisor: Prof. Günther Teubner

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Florence 1994

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Abbreviations

BGHZ	Entscheidungen des Bundesgerichtshof (Collected decisions of the German Federal High Court)
EC	European Community
EEC	European Economic Community
FAZ	Frankfurter Allgemeine Zeitung
OJ	Official Journal
NJW	Neue Juristische Wochenschrift
SZ	Süddeutsche Zeitung
ZIP	Zeitschrift für Wirtschaftsrecht und Insolvenzpraxis

A. Introduction

*"Das Wesen des Konzerns hat etwas unbestimmt Schillerndes. Es wird vergebene Mühe sein, eine allgemein verwertbare juristische Definition herausarbeiten zu wollen."*¹

The group of companies (*Konzern*) is characterized by the unity of the whole and the variety of its members.² The members are different companies, all legally independent and with their own legal personality. They are unified in a group since -according to the German definition- the parent company manages the group on a unified basis,³ while the subsidiaries are controlled by the parent company according to the original English⁴ and French⁵ definitions. The original English and French definitions took a more formal approach in describing the group phenomenon. Control was mainly considered to exist if the parent company had the majority of the subsidiary company's voting rights or the right to appoint the majority of the directors on the board of the subsidiary.⁶ Some years ago the 7th EC Directive⁷ on Company Law (with regard to consolidated group accounts) has taken a broader approach to define the group. By transforming the direction, French legislation included further means of exercising

¹ Hachenburg in Düringer/Hachenburg (eds.), *Das Handelsgesetzbuch* (1934), 3rd ed., Vol. 3, introduction, note 138.

² See classical formulation by Raiser, "Die Konzernbildung als Gegenstand rechts- und wirtschaftswissenschaftlicher Untersuchungen", *Schriften des Vereins für Socialpolitik* N.F. 33 (1964), p. 54: "Einheit des Ganzen und Vielheit der Glieder".

³ See the definition in the *Aktiengesetz, Gesetz vom 6. September 1965 (BGBL I p. 1089)*, hereinafter cited as *AktG*, § 18 (1) for a "Konzern", this definition is valid for all categories of companies but is rather limited in its field of application; see also the definition in the *Handelsgesetzbuch, Gesetz vom 10. Mai 1897 (RGBl. p. 219)*, hereinafter cited as *HGB*, as amended by *Gesetz vom 19. Dezember 1985 (BGBL I p. 2355)*, §§ 271 (2), 290 for accountancy purposes (as transformation of the 7th EC Directive on Company Law).

⁴ See the definitions of "parent undertaking" and "subsidiary undertaking" in Companies Act from 11 March 1985, hereinafter cited as CA 1985, s. 258, amended by Companies Act from 16 November 1989, hereinafter cited as CA 1989, s. 21, only for consolidated group accounts; and the definitions of "subsidiary company" and "holding company" in CA 1985 s. 736, 736A, inserted by CA 1989 s. 144, in general for all other fields of applications; "group" consists of a subsidiary and a holding company as given in CA 1985 s. 736, see CA 1989 s. 53 (1).

⁵ See the definition of "filiale" in *Loi n° 66-537 du 24 Juillet 1966*, hereinafter cited as *Loi 1966*, art. 354; new definition of "contrôle" in *Loi 1966*, art. 355-1, as amended by *Loi n° 85-705 du 12 juillet 1985*, and art. 357-1, as amended by *Loi n° 85-11 du 3 janvier 1985*, only for a consolidated group account, art. 355-1 has a limited field of application, e.g. with regard to the cross-holding of shares and duties to inform other shareholders about the own participation.

⁶ See CA 1985 s. 736 and *Loi 1966* art. 354, 355.

⁷ 83/349/EEC - OJ EC No 193, 18.2.1983, p. 1.

control into the definition of a group, the English definition took even up the term "unified management" (*einheitliche Leitung*). The legal orders do not thus only point to narrowly defined legal means for defining the phenomenon but to accepting (de facto) control by which means soever as the decisive point for the group structure.⁸

These definitions have different starting points and can be applied only to limited and partially different fields. They do not grasp the phenomenon precisely, the most illuminating description still seems to be that a group is based on a unified management of the different member companies. This is not a well-defined legal term and has been taken from the economic sphere into law; scholars of the different countries agree that it is a minimum criterion for a group that the member companies are submitted to a single decision-making process - on whatever means this is based.⁹ The leading role in this process is given to the group management which influences the management of the controlled companies and gives advice to them in order to establish a more or less uniform management.¹⁰ However, despite these descriptions the question remains open to what extent -on the spectrum between complete centralisation and complete decentralisation- the member companies must be coordinated and the subsidiaries' companies management must be influenced to comply with this term. More important is the economically assumed effect of the unified management which is to be described by the term "unified management": the group as a whole is viewed in economic terms as a uniform enterprise, despite the member companies being separate entities.¹¹ As a consequence, the mere holding of shares of one company by

⁸ See the inclusion of "dominant influence" and "managed on a unified basis" in CA 1985 s. 258, amended by CA 1989 s. 21. In *Loi 1966* art. 357-1, as amended by *Loi n° 85-11 du 3 janvier 1985*, the exercise of control by a control contract or by provisions contained in the undertaking's memorandum or articles is included.

⁹ See for France, Guyon, "The Law on Groups of Companies in France", in Wymeersch (ed.) *Groups of Companies in the EEC* (1993), p. 141; for Great Britain Gower, *Principles of Modern Company Law* (1992), 5th. ed., p. 121, 126ff.; for Germany Wiedemann, *Die Unternehmensgruppe im Privatrecht* (1988), p. 6f.

¹⁰ See the economic definition of unified management by Scheffler, "Konzernleitung aus betriebswirtschaftlicher Sicht", *Der Betrieb* 38 (1985), p. 2005, "the coordination and influencing of the member companies' management according to plan".

¹¹ See Gower (1992), *supra* note 9, p. 126-129; Ripert/Roblot/Germain, *Traité de Droit Commercial* (1993), 15th ed., p. 581; Wiedemann (1988), *supra* note 9, p. 6; Immenga, "The Law of Groups in the Federal Republic of Germany", in Wymeersch (ed.), *Groups of Companies in the EEC* (1993), p. 97f.; for the connection between economic unity of the group and unified management see Slongo, *Der Begriff der einheitlichen Leitung als Bestandteil des Konzernbegriffs* (1980), p. 1ff.,

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another as a pure financial investment is not sufficient to fulfil the notion of a group, notwithstanding the fact that unified management of a group is mostly based on majority shareholding. All these descriptions do not result in a clear definition, but they should be sufficient to illustrate the problem.¹²

The view of the group as a unity and as a single economic actor poses problems for the notion of a company in traditional company law. This concept, which is the starting point for the company laws of all countries, is characterised by the model of the company as a separate legal entity.¹³ The legal entity is constructed as economically independent with an autonomous organisation which is directed by a will formed only among its members. The guideline for all company activities is the company interest, whereby the primary interest of the company is to employ resources to maximize profits. The management of the company is bound by the company interest and is not allowed to take outside interests into consideration.¹⁴

This concept cannot, however, be successfully applied to companies which are members of a group. These are no longer economically independent since a link - usually based on the parent's holding of an affiliated company's shares, although it can also be based on other means such as interlocking directorates or contracts- exists between the companies for economic purposes. The precise aim of the group is to combine the resources of its member companies to enable them to cooperate closely. The central group management determines -more or less- the management of the

especially p. 94f.; see for the scene in the United States Blumberg, *The Law of Corporate Groups, Substantive Law* (1987), p. 4.

¹² The description of the economic phenomenon may bring out the problems of this organisational form. For the impossibility to develop a comprehensive legal definition of the group (*Konzern*) due to its indefinite essence, see the quotation at the beginning by Hachenburg (1934), *supra* note 1, and CREDA, *Les Groupes de Sociétés - Une Politique Législative* (1975), p. 193, the title of part 2, section 2: "La Vaine Recherche d'une Définition du Groupe en Droit Français" and its explication.

¹³ For Great Britain Gower, *supra* note 9, p. 97ff.; for France Guyon, *Droit des Affaires* (1990), 6th ed., p. 128f.; for Germany Wiedemann, *Gesellschaftsrecht* (1980), Vol. 1, p. 196f.

¹⁴ See for the concept of traditional company law, its implications, and its conflict with the group structure, each of them on a comparative basis, Geßler, "Die rechtlichen Möglichkeiten internationaler Unternehmensverbindungen in der EWG", in Lutter (ed.), *Recht und Steuer der internationalen Unternehmensverbindungen* (1972), p. 13, 20; Druey, "Aufgaben eines Konzernrechts", in Schweizerischer Juristenverein, *Referate und Mitteilungen* 114 (1980), p. 303-313; Immenga, "Company Systems and Affiliations", *International Encyclopedia of Comparative Law* (1985), Vol. XIII, ch. 7, note 3.

affiliated companies; their directors, who legally are alone responsible for the management of the company, do no longer (entirely) take the management decisions for the affiliated companies. The general assembly is normally entirely dominated by the parent company, as well as a supervisory board if it exists. The organisational order of the company which is a group member is therefore changed, since it is no longer directed by an independent decision-making process but is subordinated to (quasi) instructions of the parent company - all this in striking contrast to the single entity doctrine. The checks and balances in the company achieved by the different competences of the company institutions are therefore distorted by the dominant position of the parent in them.

The company interest may also be no longer the ultimate guideline for the decisions taken by the affiliated company's directors. As the parent company pursues its own specific entrepreneurial interests, it will also determine -to a greater or lesser extent- the interest of the affiliated company; an outside interest may supersede the interest in the company. The profit maximization principle on which all shareholders of a company normally agree and which also serves the interests of the creditors may be different in the case of groups: maximizing profits on behalf of the group is not always synonymous with maximizing profits for the affiliated company. Such a shift of the subsidiary's profits (and assets) may be facilitated by the often close economic cooperation in the group which allows the transfer of profits and assets in the form of normal business transactions. However, this view only of the dangers of the group for the company is rather one-sided as it does not make allowances for the possible (large) advantages for the affiliated company resulting from its being part of a group. This is simply a short summary of how the notion of a unified management and the economic unity of the group can change the concept of the company as a separate legal entity and may cause dangers for the other parties which have a stake in the affiliated company.¹⁵

¹⁵ Groups also provide an institutional distortion at the level of the parent company, see especially the Lutter school, Lutter, "Organzuständigkeiten im Konzern", in *Festschrift für Walter Stimpel* (1985), p. 825ff.; Timm, *Die Aktiengesellschaft als Konzernspitze* (1980); Hommelhoff, *Die Konzernleitungspflicht* (1982); however, as this study will not deal with this problem a further analysis is not necessary.

In order to see how relevant the problem is in reality and to what extent the group has replaced the model of the independent company, it is useful to take a look at data about the importance of groups in the economic life of France, Germany, and Great Britain, representative countries of the Member States of the European Union.

I. The Importance of the Group in Economic Life

Due to the poor definition of the group, its great flexibility and diversity there are no comprehensive and comparable official statistics about this phenomenon.

In Germany, 511 groups were obliged to set up a consolidated group account in 1986 following an at that time applicable law; 280 of those controlled 5582 subsidiaries, thus on average about 20 per parent. The total turnover of these groups was 1100 billions DM, 2.2 billions DM per group, and their share of the total turnover of all German enterprises was approximately 28%. The number of the groups in total did not grow very much between 1970 and 1986, although the number of the subsidiaries per parent grew rapidly.¹⁶ According to a rough estimate, between 75% and 90% of the public companies (AGs) in Germany are members of a group, at least the same amount as the private limited companies (GmbHs).¹⁷ General opinion is therefore that for medium-size or large enterprises the group is the most widely used structure.¹⁸

A similar situation can be found in France. Links between companies are very common and the economic scene is dominated by large groups. It is estimated that the major groups hold on average about 400 subsidiaries¹⁹. In recent years, the group structure has no longer been used only by large companies; medium-size and small family businesses also make use of this technique of organisation, in which all forms

¹⁶ Kaiffass, "Ökonomische Analyse der Konzernbildung", in Mestmäcker/Behrens (eds.), *Das Gesellschaftsrecht der Konzerne im internationalen Vergleich* (1991), p. 20-23.

¹⁷ Ordelheide, "Der Konzern als Gegenstand betriebswirtschaftlicher Forschung", *Betriebswirtschaftliche Forschung und Praxis* 38 (1986), p. 294; Theisen, *Der Konzern* (1991), p. 1.

¹⁸ Wiedemann (1988), *supra* note 9, p. 7; Theisen, "Konzernorganisation", *Die Betriebswirtschaft* 46 (1986) p. 747; Ordelheide, *ibid.*, p. 294.

¹⁹ Cf. the study of 32 groups in France and their holding of shares in other companies, CREDA (1975), *supra* note 12, p. 13ff., 341ff.; for a survey cf. Antunes, *Liability of Corporate Groups* (1991), p. 71.

of companies can be involved²⁰.

A study of the situation in the United Kingdom shows that in 1981 the 50 largest British groups each had on average 230 subsidiaries, partly on many different levels and in extremely complex structures.²¹ A survey from 1993 listed 100.000 UK registered companies, which were part of groups headed by a UK company.²² British scholars have therefore concluded that there might be some evidence to suggest that the use of the group form may be more widespread in the United Kingdom than in other comparable economies.²³

This summary shows the overwhelming importance of the group form for national economies. Still greater is the significance of the group structure for international business organisations. Setting up subsidiaries almost is the only possibility for an enterprise to carry out business on its own in foreign markets, therefore the group is the most important organisational structure for international enterprise cooperation and for integrating markets (with exception of the market itself).²⁴ Furthermore, it shows that in reality the model for economic organisation is no longer the single independent company, but the group structure with several subsidiaries - at least for medium-size and large enterprises.

II. Groups between Economic Organisation and Legal Structure

The law has reacted to the overwhelming importance of group structures by means of national and European legislation for different fields, especially in tax law, banking and capital market law, labour law, and -already mentioned- accountancy law. In company law -as the original field for the classification of groups- such developments did not

²⁰ Guyon (1993), supra note 9, p. 142f.

²¹ Tricker, *Corporate Governance* (1984), Ch.5.

²² Kompass, *The Authority of British Industry - Parents and Subsidiaries 1993/1994* 3rd ed. (1993), especially the introduction.

²³ See Hadden, *The Control of Corporate Groups* (1983), p. 1, 11; Prentice, "A Survey of the Law Relating to Corporate Groups in the United Kingdom", in Wymeersch (ed.), *Groups of Companies in the EEC* (1993), p. 279.

²⁴ See fourth reason for the draft proposal of the Ninth Directive in Company Law from 1984; published in *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 14 (1985), p.446.

take place to a great extent; in 1965, Germany enforced a special regime which acknowledges the unity of the group but is only applicable for groups in which AGs are subsidiaries, only Brasil, Portugal, and Hungary followed its example. The German approach was thought to be comprehensive for AGs, but proved to be incomplete and in some regards insufficient even in its limited field of application.²⁵ In other countries where no special regime for groups has been established, legislation has been adopted for a few, very specific points regarding groups, but, in general, in these countries and to a large extent also in Germany the phenomenon of the group is still dealt with by traditional company laws, in modified in part by courts. The question therefore still remains as to what the guiding considerations for company law with regard to groups should be. Different approaches can be found in order to determine the functions and the tasks the law has to fulfil in dealing with groups.

One approach which is mainly based on legal considerations views the group primarily as a distortion of company's legal structure and the just balance of interests produced by these structures, as shown above. It is therefore especially concerned with the interests of minority shareholders and creditors of the affiliated company. As it is no longer possible to prohibit the formation of groups, especially by forbidding the shareholding of one company in another company, the protection of the affiliated company and, at the same time, of the interests of creditors and minority shareholders against the -at least detrimental- influence of the parent is to be seen as one way of assuring this; detriments which have arisen have to be compensated by the parent. This solution holds to the model of the company as an autonomous entity, whose independence should also be maintained by company law in a group. Consequently, the situation in which the company would be if it were not member of a group is reference point for balancing detriments, as a form of extending liability on the parent.

²⁵ This approach accepts a unitary view of the group for groups based on contracts, *AktG* §§ 291 ff.; the provisions for de facto groups are oriented on the model of the company according to traditional company law, *AktG* §§ 311 ff. No allowances are made for changes by the group structure on the level of the parent company, see for the shortcomings of the treatment of groups in the *AktG* 1965 Schneider, "Der Konzern als Rechtsform für Unternehmen", in Mestmäcker/Behrens (eds.), *Das Gesellschaftsrecht der Konzerne im internationalen Vergleich* (1991), p. 563-565.

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Another approach is especially concerned with large enterprises and in particular groups as powerful private institutions whose power for "private government" is not publicly or democratically legitimized. Here, the managers strive in particular for an increase of their power and use their managerial discretion for the unregulated creation of industrial empires. The main task for the law with respect to groups would thus be the establishing of a strict legal control over these or to integrate representatives of all affected interests, especially representatives of the public interest, in the decision-making process of the group.²⁶

A more modest approach would take the function of the group as a starting point, namely that it is a form of business organisation. From the economic point of view, a business organisation especially serves reasons of efficiency²⁷; thus the main purpose of a business organisation is to provide an organisation for an efficient²⁸ allocation of resources. In a market economy efficient business organisations are especially characterised (and, at the same time, their efficiency is measured) by their success in the market(s) and a maximization of their profits by market transactions. Business organisations may also serve further goals, but their structure has to be aligned particularly to the predominant goal of efficiency and market success.

By providing the economic organisations which are necessary for an efficient resource allocation, the power which is inevitably inherent in a large enterprise/group

²⁶ For the corporation see Mason, *The Corporation in Modern Society* (1960), p. 7-9; Steinmann, "The Enterprise as a Political System", in Hopt/Teubner (eds.), *Corporate Governance and Directors' Liability* (1985), p.401ff.; for groups Hadden (1983), *supra* note 23, *passim*; id., "Inside Corporate Groups", 12 *International Journal of the Sociology of law* (1984), p. 271ff.; Bercusson, "The Significance of the Legal Form of the Group Enterprise in the United Kingdom", in Sugarman/Teubner (eds.), *Regulating Corporate Groups in Europe* (1990), p.267ff.. With a different starting point Hommelhoff (1982), *supra* note 15, p. 499, who attempts to use internal organisation law for the group in order to install checks and balances for the power inherent in the group, especially by granting greater competences to the general assembly in all questions which are relevant for group matters.

²⁷ See only Williamson, "The Modern Corporation", 19 *Journal of Economic Literature* (1981), p. 1537f., 1564.

²⁸ For the main definitions of efficiency by Pareto and Kaldor-Hicks see Posner, *Economic Analysis of Law* (1992), 4. ed., p. 12-14; Kübler, "Effizienz als Rechtsprinzip", in Baur et al. (eds.), *Festschrift Steindorff* (1990), p. 694f. In this study the term "efficiency" will be used in the sense of the Kaldor-Hicks concept, therefore an allocation of resources is efficient if the benefit of the winners is greater than the harm done to others, so that the winners could compensate the others. For a special treatment of efficiency regarding organisations see below note 35.

and necessary for fulfilling its tasks is economically and therefore socially justified; the group is therefore legitimized by pursuing the goal of efficiency.²⁹ These goals of efficiency and profit maximization by transactions in the markets also control the exercise of power by the group. The group is not an instrument for the accumulation of power for use by the management in an arbitrary way afterwards but is only entitled to use its power for a specific purpose - to secure an efficient resource allocation. Competition in the various markets which the group is exposed to - especially product markets, financial markets and the market for corporate control, and markets for loans - ensures that the enterprise pursues the legitimizing goal of efficiency. Further internal control mechanisms, in addition to the checks and balances already established by company law, especially the integration of further interests into the company as proposed in the previous approach, should be secondary only to the control exercise by the market. New internal control mechanisms are only necessary if it can be shown that the market forces are not strong enough to control the group and to compel it to focus its activity on the achievement of efficiency and market success. This would be especially the case if competition were lacking.³⁰ However, this primarily is a task for anti-trust law rather than for company law.³¹

²⁹ See Buxbaum, "Corporate Legitimacy, Economic Theory, and Legal Doctrine", 45 *Ohio State Law Review* (1984), p. 518f.

³⁰ cf. Buxbaum, *ibid.*, p. 515ff., especially p. 518f., 520-525. For market and competition as main controlling device see the representatives of the *ordo-liberal* school Streit/Müssler, "The Economic Constitution of the European Community - from Rome to Maastricht", *EUI Colloquium Papers*, DOC.IUE 72/94 (1994), p. 6; Hayek, "The Corporation in a Democratic Society: In Whose Interest Ought It To and Will It Be Run?", in *Studies in Philosophy, Politics, and Economics* (1967), p. 300ff., who argues for the profit principle (only in favour of the shareholders) as only goal of the enterprise in order to exercise control over it. In a similar respect critical regarding Hommelhoff's approach (*supra* note 26) Rittner, "Konzernorganisation und Privatautonomie", *Archiv der civilistischen Praxis* 183 (1983), p. 306f., 307f., as a strict legal determination of the group organisation by company law would not lead to better control of the company, but would prevent the interested groups from searching autonomously for their own solution.

³¹ The group form is well-suited to concentration in the economy; according to one approach, the law for groups of companies therefore should -among others tasks- avoid advantages of concentration in a group structure, cf. Monopolkommission, *Hauptgutachten VII (1986/87)*, note 796ff.; Kübler/Schmidt, *Gesellschaftsrecht und Konzentration* (1988), p. 7ff., 16ff.; very critical see Rittner, "Gesellschaftsrecht und Unternehmenskonzentration. Zu den Vorschlägen der Monopolkommission", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 19 (1990), p. 203ff. However, it seems to be preferable not to superimpose the values of anti-trust law on company law for groups as the latter does not discriminate between groups which are able to avoid competition and those which choose the group as a suitable form for their business purposes or even find their origin in deconcentration purposes. See for a very straightforward subordination of the law for groups under antitrust law Emmerich/Sonnenschein, *Konzernrecht* (1993), 5th ed., p. 19, who want to deduce from the German and European antitrust law

Company law must take the main aims of companies, namely of being business organisations and of carrying out efficient economic activity, as a basis in order to shape a legal structure for them.³² Its fundamental task is to enable a number of people to combine their resources and to participate collectively in economic activity. It sets up rules for an expedient adjustment of the shareholders' behaviour, but it also has to take into account the other groups which have a stake in the company, such as creditors, employees, and the public.³³ Company law structures the company in order to provide for an equal and just balance of the affected interests and has to safeguard these interests against typical dangers. Translated into the language of economics, there must be incentives for the different groups of stakeholders to make available the necessary resources; the law has to provide these incentives by establishing mechanisms which safeguard the resources against misuse by other groups afterwards. Thereby, law defines a suitable general standard for the protection of affected interests, whose subjects can have confidence in the fairness of the defined standard, and avoids high (transaction) costs which would occur if the necessary protection had to be individually re-negotiated

that the law for groups in tendency has to be unfavourable for groups and want to justify the primacy of the protection of the creditors and affected shareholders from this starting point. However, it does not seem to be reasonable to incorporate a general statement of antitrust law as a value into the law for groups without taking over the differentiations in antitrust law. Moreover, there seem to be no reasons to derive the protection of creditors and minority shareholders from quasi metaphysical values of the economic order, if, instead, the relevant criteria can be taken from the tasks and function of company law in this specific field. In general, company law is not a value-free, only neutral organisational law without effects on the economic order, but it seems to be too narrow to view company law mainly under the aspect whether the legal structures of companies further concentration or not, company law has to take into account mainly other values out of other relations, not only the standing of the company in competition. Therefore the principle of free competition in a decentralised economic order with small economic units is not the main aspect for the design of companies by company law, it may be taken into account as one aspect among others, see Wiedemann (1980), supra note 13, p. 725-730. By showing that the group leads to economic efficiency one may help to reduce prejudices against this organisational form, see Teubner, *Recht als autopoietisches System* (1989), p. 154.

³² A further aspect for determining the tasks of company law can be distributive justice, see Behrens, "The Firm as a Complex Institution", *Journal of Institutional and Theoretical Economics* 141 (1985), p. 62ff. However, it is not clear in favour of which groups of stakeholders (only creditors and shareholders are relevant for this study as the affected parties in a narrowly defined field of company law, excluding employees) and in which fields company law has to consider effects of distributive justice and in how far these effects cannot at the same time be expressed in efficiency considerations. See in general for the limits of the efficiency principle in law, but also for its possible wide range of application, especially in such economically formed areas as company law, Kübler (1990), supra note 28, p. 687ff.; for a limited competence of economics in a discussion of the legal system in this respect even Posner (1992), supra note 28, p. 14.

³³ Lehmann, "Das Privileg der beschränkten Haftung und der Durchgriff im Gesellschafts- und Konzernrecht", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 15 (1986), p. 346.

for each transaction of resources. It is in this way that company law is able to serve efficiency.³⁴

Company law not only forms relationships between the affected groups efficiently but also provides for legal structures by which the goal of business organisations can be performed efficiently, to carry out various kinds of economic activity.³⁵ Company law provides for a number of different legal structures to be chosen by economic organisations according to their needs - the requirements which make it possible for the concrete firm in question to carry out efficient economic activity.³⁶ It not only provides for different types of business organisations, so that enterprises can select the most suitable for their purposes, but it also shapes the internal legal structure of the company so that efficient economic activity can be carried out; thus that companies are able to achieve the purposes for which they are set up without unnecessary legal restrictions.

In both respects the function of the law does not seem to perform a leading role in inventing new structures for enterprises, but rather to accomodate economic developments and to stabilize organisational forms which already have been developed.³⁷ The structures of collective participation in economic activity were shaped by economic realities before being transformed into legal structures. As a later development of company law (at least in Germany) the combination of different legal forms also derived from particular economic realities for which the legal sphere then established rules.³⁸

³⁴ cf. Posner (1992), supra note 28, p. 396f.

³⁵ See for the difference between the general resource allocation efficiency and the efficiency of the organisation itself Milgram/Roberts, *Economics, Organization, and Management* (1992), p. 23f.; Scholz, "Effektivität und Effizienz", in Frese (ed.), *Handwörterbuch der Organisation* (1992), 3rd ed., columns 533f., the efficiency of organisations is measured with regard to the outcomes the organisations generate, more precisely the relationship between inputs and outputs is measured, particularly in comparison to other organisations performing the same task.

³⁶ See Schanze, "Recht und Ökonomie des Unternehmens", *Zeitschrift für die gesamte Staatswissenschaft* 137 (1981), p. 695-698.

³⁷ In general for these goals as main task of "enterprise constitutional law" Teubner (1989), supra note 31, p. 151f.

³⁸ cf. Schanze (1981), supra note 36, p. 698.

The internal organisation of a company is more determined by economic and organisational considerations than by a given legal structure to the company, although the legally provided internal structure clearly predetermines the organisational structure to some extent. The legal rules should not interfere with the requirements of an efficient economic organisation; rather, they have to adapt to a priorly developed, efficient company organisation and to stabilise this by legal means - without, of course, neglecting other interests which must be protected. Therefore, this approach does not imply that the law has to accept every development coming from the economic sphere even if the development would per se endanger the protection of the interests. Nevertheless, by adopting an efficient internal organisation and formulating it into general legal rules which fulfil the required economic functions, the law sets a general standard and directs the general development of the organisational structure towards a more efficient organisation.

These considerations about efficiency as the main task of company law can also be employed for the group structure. The importance of groups enjoying adequate conditions for an efficient economic activity for themselves and -on a macro level- for the whole economy can be seen in the significance of group structures for economic life. Because of the wide diffusion of group structures in reality, it may also be surmised that they are especially suitable for many economic purposes as enterprises choose the group structure among various competing company forms. Company law should therefore accept the structure of the group as a normal type of organisational structure for a business enterprise. The other alternative, strict adherence to the model of the autonomous and independent company and the attempt to enforce it for subsidiaries is a concept ill-suited for groups and does not fit the real developments.³⁹ Therefore the first, before mentioned approach for dealing with groups, which was mainly concerned with legal considerations, is unable to deal adequately with the position of a company in a group and to develop an adequate legal structure for the group. Moreover, as groups per se are not forbidden by company law in the different countries, it would be a contradiction if, on the other hand, company law set constraints

³⁹ See Geßler (1972), supra note 14, p. 13, 20f.

on groups, hindering the efficiency of their organisation organised and keeping them away from performing efficient business. The law has also to give attention to its efficacy. If economic law is directly opposed to the gains of efficiency by the economic actors, it runs the risk of not being accepted by the actors affected and therefore of being effectless. In the direct confrontation between the law and the efficiency (or profit) principle, there is a huge incentive for the economic actor to follow the latter; the law could, therefore, lose its chance to have an impact on the activity of groups.⁴⁰ On the other hand, accepting the group form does not mean that the law should provide it with a legal personality or align the group to given legal forms of companies, but it should take the group seriously as one form of business organisation, stabilise it, and draw up -if necessary- special rules for it.

The question arises as to what the requirements for an efficient law of company groups are. On the one hand, such law has to secure the interests of the actors who are affected by the group in order to avoid the externalization of costs. On the other hand, it has to provide for adequate legal conditions so that the group as an organisation can work efficiently. The key for efficient group activity seems to lie in the purpose for which they are formed: to combine the resources of the different companies in order to reach common goals which could not be attained if the companies were still unconnected, and to be capable of acting as a uniform economic unit. This combination of resources is achieved by substituting (at least partly) a market relationship between the companies by internal organisation. The internal organisation and the decisive link between the companies is produced by unified management, exercised over all the group members. To reach these common goals the coordination of members and a uniform organisation is needed.

The crucial point with regard to company law seems to be the question whether it leaves enough room for a central management so that the group can achieve the goals of cooperation for which it has been formed. The concept of traditional company law

⁴⁰ Teubner, "Unitas Multiplex", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 20 (1991), p.192f.; Hübner, "Recht und Organisation", in Grochla (ed.), *Handwörterbuch der Organisation* (1980), 2nd ed., column 2007.

is more or less opposed to unified management; as a result the central management seems to be impeded in its goal to achieve the benefits of a combination of the companies' resources. Nevertheless, to build up a uniform organisation and exploit the advantages of combined resources, various degrees between a centralized and decentralized management seem to be possible. In order not to dismiss the concept of company law from the very beginning in the analysis of whether the concept and provisions of company law are compatible with an efficient economic activity of the group, we must take the minimum of central management as a point of comparison, and establish the minimum degree which is necessary to achieve the advantages of the resource combination. For the resulting organisational structure we must ask whether it can be balanced with the legal concept, the single entity doctrine, and whether the legal provisions can be interpreted in such way that they are compatible with this economic organisational form.

This does not mean that the only task of company law is, by dealing with groups, to facilitate unified management to an appropriate extent for the efficient activity of this organisational form; but it should also provide an efficient structure for the interests of other groups which have a stake in the company.⁴¹ At the outset, the single entity doctrine has been developed to guarantee a balance between the affected actors in the independent company. Given the situation has changed and the group has in reality become the prevailing model the above-defined economic structure may be suitable as a basis to determine how a deviation to this extent from the legal concept changes the position of the affected actors, and to decide whether the traditional concept of company law is still capable of providing a balance of the affected interests or whether additional measures for these are necessary. As an alternative to the solution that company law should adapt to the changed situation one could claim, as the first, earlier-mentioned approach does, that it should enforce the concept of the company as

⁴¹ cf. Kallfass (1991), *supra* note 16, p. 48, who argues for a selective legal framework which makes the exploitation of economies possible, but prevents other concerned actors from being negatively affected by this organisational form. For another typically economic position which wants to limit the goal of company law granting a considerable latitude to companies in order to give them the possibility of building an efficient internal organisation Williamson, "The Economic Analysis of Institutions and Organizations - in General and with Respect to Country Studies", *OECD Working Papers*, No.133 (1993), p.53. Nevertheless, he is also concerned with limiting managerial discretion.

an independent entity, object to the central management of groups, and protect the affected interests in this way. However, as company law does not forbid groups per se this solution seems to be highly unrealistic, for not to say unreasonable. Thus company law should adapt its concept to protect other interests in the given situation and should not try to capture reality.⁴²

III. Structure of the Study

Economic and legal structure of the group are to be analysed, thus economic and legal considerations determine the structure of the study. The group is a phenomenon which can be placed on the borderline between economics and law, as it consists of legally independent companies which are linked by an economic and organisational connection; both disciplines have to cooperate for understanding the phenomenon. The law has to take into account the economic preconditions of the group and the economic advantages of its formation in order to analyse legal questions regarding the room for central group management granted by the law, the change of the single entity doctrine by the group, and the impact this change has on the positions of the various affected actors.⁴³ If the law does not consider the economic aspects, it will not be able to perceive the consequences of the legal provisions and will fail to provide for an efficient (and just) regulation of the group phenomenon.⁴⁴

In its economic section this paper will start by examining what gains in efficiency can be achieved through coordination of resources within enterprises; thus,

⁴² See Geßler (1972), supra note 14, p. 13, 20f.; Hommelhoff (1982), supra note 15, p. 224 note 36, who states that "it is impossible to enforce the factual independence of a company which has become dependent on another company by the means of the law".

⁴³ For the need to employ economic considerations in order to grasp the group see already Mestmäcker, *Verwaltung, Konzerngewalt und Rechte der Aktionäre* (1958), p. 7; Kirchner, "Ökonomische Überlegungen zum Konzernrecht", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 14 (1985), p. 215, 218f.; Hübner (1980), supra note 40, column 2007.

⁴⁴ For the fruitfulness of an application of the economic analysis of law in this respect Kübler (1990), supra note 28, p. 687ff., especially p. 693f., 703f. See, however, Reuter, "Die Personengesellschaft als abhängiges Unternehmen", *Zeitschrift für Handelsrecht* 146 (1982), p. 26-29, arguing for a complete primacy of legal values without taking into account economic considerations or consequences but only for taking into account the limits of economic knowledge so that economic consideration seem to be absolutely useless for the legal dealing with the problem; the question remains whether it is really enough if the law designs artificial constructs without referring to (economic) reality.

the advantages that an internal coordination of resources may have over market coordination. Then, it will focus on the internal organisation of enterprises and analyse in which way a decentralised management can achieve these goals. General patterns of an efficient internal organisation will be worked out, whereas the organisational concepts of different enterprises will vary in detail as they adapt their organisation to individual needs. Special attention will be paid to the needs of medium-sized or large enterprises as these mostly choose the group structure.

After this, it will be shown how this economic organisational form fits the structure of the group -consisting of different legal entities- and in which way groups must be internally organised in order to reach the goals of efficiency of a firm with a minimum of unification and unified management. In this section the position of the companies within the group, the tasks which they must perform and how groups can be structured in general will be examined. Furthermore, it will be demonstrated how management responsibilities are divided between the top of the group and the single affiliated companies in order to ensure that the group as a whole can achieve the advantages of firm coordination or, to put it more simply, the degree to which unified management is needed. The tasks of the central group management will be defined in more detail, the areas of decision-making with which it is concerned, how specific its decisions can be in the different fields, and the means it uses to prepare and enforce its decisions. In a final step in the economic part it will be shown why the organisation in a group structure is especially efficient for enterprises and how the division of business activity upon different legal companies is particularly appropriate for efficient forms of economic organisation.

These findings must be compared with company law in order to see, in which fields company law (in the interpretation of the courts) already complies with the economic requirements of efficient organisation and which of these can be interpreted according to those requirements. As means of comparison, the company law of the German *GmbH* will be used. The concept and the provisions -which restrict the unified management and the activity of the group with a *GmbH* as an affiliated company- will be compared to the economic criteria developed referring to which areas and in which

way a minimum of unified management should be performed. Furthermore, references to other legal orders will be made if there are solutions which have been developed for comparable legal problems.

Next, the extent to which the described organisational structure with a minimum of unified management can affect the position of a company's creditors will be examined. In this field it will be analysed whether the limited liability of an affiliated company in a group can be justified, and therefore whether the legal precautions are still sufficient for the creditors, i.e. whether their risk is unpredictable and increased by the simple fact that the company is member of a group, and whether the privilege of limited liability can still be justified for members of a group in general. Since the assuming liability on the parent for the debts of a subsidiary can be understood as a restriction on the unified management and a sanction on a too far-reaching determination of the activity of the subsidiary by the parent, the extent to which a unified management is compatible with the limited liability of the affiliated companies is also important for the group. If an organisational model can be developed according to which the parent company is in all cases exempted from liability for a subsidiary, the parent can adjust its planning to this structure. This would also increase the legal certainty in this field. Particular attention will be paid to recent cases of the *Bundesgerichtshof (BGH)* in which it adjudicates on piercing the corporate veil and assigning liability to the parent company for debts of the subsidiary, and which have not fixed precisely the circumstances in which the liability should be extended to the assets of the parent. Regarding this point a comparative method will also be used.

B. Economic Organisation of an Enterprise

I. Market and Hierarchies in Terms of Efficiency

Markets and firms represent alternative methods of coordinating production, and more

generally, of coordinating the allocation of resources.⁴⁵ In the market, the allocation of resources is coordinated without any central planning, and instead prices direct the use of the resources in the market. Prices in this case are adjusted by the forces of supply and demand and are such that supply equals demand for each good. The resources are led to its actual use by a series of exchange transactions in the market. Within the firm, on the contrary, market transactions are eliminated, and the price mechanism is usually replaced by the decision of the entrepreneur. The allocation of resources is no longer dependent on the changes of relative prices; instead, the management formulates general strategies and goals, develops specific plans to realize these goals, and then directs people to carry out their specified roles using the resources they have been allocated, administrative processes and procedures are instituted to guide activity. The supersession of the price mechanism seems to be the distinguishing mark of the firm. As firms and markets are alternative modes for allocating resources, or -to put it in another way- for organising the same transaction, an explanation for the choice is needed. The question of why all the allocation of resources are not determined by prices and why firms build such a costly administrative structure to perform in the same way as the market arises. In general, the question is therefore why are there firms at all?⁴⁶

If the market were in all instances the most efficient organisation for the allocation of resources, there would be no need for any other economic organisations. These organisations can be thought of as arising and supplanting the market when they offer more efficient mechanisms for coordinating economic activity and if the market does not lead to efficient outcomes. Thus, to answer the question one should examine which goals of efficiency can be served by firm co-ordination of resources rather than by market coordination, or -to put it in another way- under which circumstances a firm can coordinate resources at less cost than the market. There may be other reasons for a firm co-ordination of economic activity apart from those of efficiency, such as the quest for monopoly gains or the wish for power by managers. However, markets and

⁴⁵ The need for various means to coordinate economic activity derives from the concept of specialization as the basis of modern economy; this allows for enormous increases in productivity, see e.g. Milgrom/Roberts (1992), *supra* note 35, p. 25f.

⁴⁶ See Coase, "The Nature of the Firm", *Economica* 4 (1937), p. 388f.

firms as alternative modes for allocating resources and organising the same transaction are competing with each other. Moreover, the firm itself is attached to the market and has to prove there that it is able to allocate resources more efficiently than alternative methods. As an economic organisation, especially in the long run, will not be viable if it is less efficient than another which serves the same purposes, it is assumed that the main reason for firm co-ordination is that of greater efficiency.⁴⁷ Hence, in the market for institutions the firm can be chosen instead of the market for reasons of efficiency in order to allocate resources.⁴⁸ A greater efficiency is of benefit to the firm, as it strengthens its competitiveness in the market, as well to the whole economy, as it leads to a more efficient allocation of resources.⁴⁹

The goals of efficiency which can be achieved by firm coordination of resources may not only explain why firms exist but may also determine what a firm does⁵⁰, therefore which functions of the market can be taken over by the firm for reasons of efficiency. To refer back to the topic of this study, this may help to understand why a unified management of companies in a group may be more efficient than a market relationship between them, and which functions may therefore be taken over by internal cooperation.

Gains of efficiency by the allocation of resources in a firm can mainly (not exclusively) result from exploitation of economies of scale and scope, or from the reduction of the costs of the transactions involved. Transaction costs economies are closely related to those of scale and scope and they need to be addressed simultaneously to understand which goals of efficiency can be achieved by firm coordination.⁵¹

⁴⁷ Williamson (1981), *supra* note 27, p. 1537, 1564; explicitly for the reliance on competition for an evolutionary selection of the more efficient form, *id.*, *The Economic Institutions of Capitalism* (1985), p. 17, 22f., 273; more general for efficiency as a positive principle which determines the survival of all kinds of organisations, Milgram/Roberts (1992), *supra* note 35, p. 24f.

⁴⁸ cf. Coase (1937), *supra* note 46, p. 386ff.

⁴⁹ Coase, "The Problem with the Social Costs", 3 *Journal of Law & Economics* (1960), p. 15-17.

⁵⁰ cf. Coase, "Industrial Organization: A Proposal for Research", in Fuchs (ed.), *Policy Issues and Research Opportunities in Industrial Organization* (1972) p. 63.

⁵¹ Chandler, *Scale and Scope* (1990), p. 17f.; Williamson (1981), *supra* note 27, p. 1547-49; transaction costs have to be addressed simultaneously with economies of scale and scope as in a world without transaction costs economies of scale and scope could be exploited by one firm which as well produced for its rivals, see Williamson (1985), *supra* note 47, p. 92 note 8.

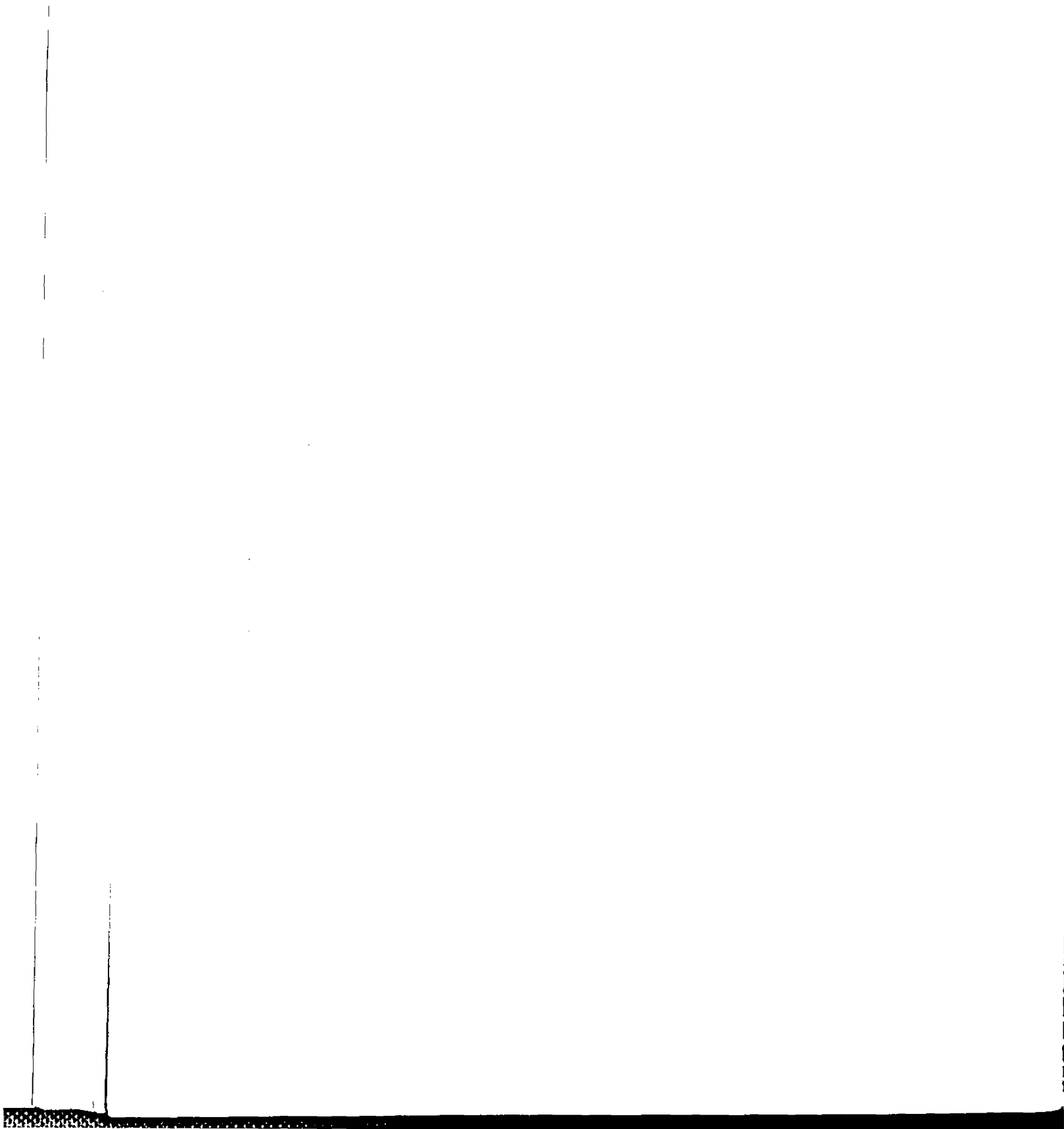
Further insights for the advantages of firm coordination may also be gained by an examination of how the different arrangements deal with information. After this, the different explanations for the advantages of firm coordination will be applied to the most common developments of the firm to vertical and horizontal integration.

1. Economies of Scale and Scope

Firm coordination can lead to gains of efficiency over market coordination by exploiting economies of scale and scope in all areas in which a firm operates. Economies of scale can be defined as those which result when the increased size of a single operating unit handling (especially producing or distributing) a single product reduces the unit cost. The decrease of unit costs particularly result from a reduced share of fixed and sunk costs per unit and advantages of specialization of equipment and workers.⁵²

At first, economies of scale are based on (normally very capital intensive) production technology by means of which a large volume of output can be produced at low unit costs. However, a production plant alone is not able to exploit economies of scale, but all parts of the firm have to be adjusted to the volume of sales the firm anticipates. The firm has to adapt its sales forces, its supply, and distribution facilities and equipment to the anticipated scale of operation. Mistakes associated with incorrect perceptions of scale by parts of the organisation - e.g. having too few raw material or components to keep an expensive factory operating at full capacity or delays in the supply of these - can have grave implications on other parts of the enterprise and can lead to very high costs. Thus, the management of the firm will make special efforts to coordinate the different parts of the firm very precisely or will take care that the various units coordinate themselves so that the possible economies of scale can really be achieved by close cooperation between the various parts of the firm. Moreover, economies of scale do not only depend on the size of the firm, but the management also has to reflect the (anticipated) size of the market for the product. If the market does not demand the volume of goods produced the unit costs rise rapidly as the sunk costs of

⁵² Chandler, *ibid.*, p. 17; Bühner/Weinberger, "Cash-Flow und Shareholder Value", *Betriebswirtschaftliche Forschung und Praxis* (1991), p. 198.



the capital investment and the fixed costs remain independent. Therefore, the management will forecast the expected growth of the market by taking into account that scale economies make lower prices possible and that this may increase demand and will attune the whole firm to the anticipated size of the market.⁵³

Economies of scope are those cost reductions resulting from the use of processes by which more than one product can be produced within a single unit.⁵⁴ Cost advantages result from the common use of indivisible production factors. These can be common components which are cheaper to produce together for several products, they can make a better use of management or financial means. Economies of scope entail all the needs for coordination as economies of scale; close cooperation is required between the parts which make available the common production factor and the parts which use it. The coordination problems are frequently even more complex as coordination in planning may be required among managers responsible for different products.

Scale (or scope) economies can also appear at the level of product development.⁵⁵ A firm may acquire generalized expertise in the important skills that are required to design and market new products in a set of related markets or using a set of related technologies. Modern management theory has labelled such economies with the name "core competencies of the firm". Core competencies are in principle a shared element of the various products; the particularity of this element is that the cost of building up this competency is shared with a series of products that do not yet exist, since the gains of the newly acquired capabilities may only come over a longer period of time. The different parts of the firm involved have to cooperate closely to achieve these common competencies.

Particularly important in relation to this study is that economies of scale and

⁵³ See Chandler, *ibid.*, p. 21-34; Milgrom/Roberts (1992), *supra* note 35, p. 106f.

⁵⁴ See Teece, "Economies of Scope and the Scope of the Enterprise", 1 *Journal of Economic Behavior and Organization* (1980), p. 223ff.; Chandler, *ibid.*, p. 17, 21-32; Bühner/Weinberger (1991), *supra* note 52, p. 198f.; Milgrom/Roberts, *ibid.*, p. 107.

⁵⁵ See Milgrom/Roberts, *ibid.*, p. 106f., p. 554f.; for the importance of these competencies for the modern business enterprise from a historical point of view, Chandler (1990), *supra* note 51, p. 41f.

scope do not only depend on having the technological facilities which make the mass production of a good possible; but for achieving the actual cost advantages the management has carefully to coordinate the complementary⁵⁶ activities all necessary to exploit the actual economies of scale and scope in the enterprise. Thus, the actual economies depend on management and organisation; the visible hand of administrative coordination is able to make more intensive use of resources than the invisible hand of market coordination could do.⁵⁷ Transferred to a group in which the member companies fulfil the different complementary functions of an enterprise it shows that group management's coordination is necessary in order to exploit possible economies of scale and scope for all the companies together.

2. Economising on Transaction Costs

The coordination of resources by a firm can also lead to gains in efficiency (in comparison to market coordination) by economising on transaction costs. The transaction cost approach finds its origins in the work of Ronald Coase; it has been expounded and made more operable in the work of Oliver Williamson.

a. Basis of Transaction Costs Economics

Transaction costs economics does not see the firm mainly as a production function the size of which is determined by the (technological) necessities of exploiting economies of scale and scope but, rather, focuses on the firm as a governance structure for transactions.⁵⁸ Its basis is a comparative analysis of different organisational forms with respect to their ability to govern transaction at lower costs: in the framework of transaction cost economics, the firm has a role to play in the economic system if it is capable of organising transactions at lower costs than those which would be incurred if

⁵⁶ See for the complementarity of activities, Milgrom/Roberts, *ibid.*, p. 108.

⁵⁷ See for a very impressive historical explanation how management was necessary to achieve these gains in efficiency in the modern business enterprise Chandler, *The Visible Hand* (1977), p. 364; *id.* (1990), *supra* note 51, p. 24-28.

⁵⁸ See Williamson, *supra* note (1981), p. 1539f; see also Chandler, *supra* note (1990), p. 14f. who gives more weight to the firm as an instrument to achieve economies of scale and scope.

the same transactions were carried out through the market. It sees the distribution of economic activity between firms and markets as being mainly dependent on their ability to economise on transaction costs, the tendency -due to the institutional competition between the different organisational forms for the most efficient solution- being to adopt the organisational mode which best economises on transaction costs.⁵⁹ The limit to the size of the firm would be set when the scope of its operation has expanded to the point at which the costs of organising additional transactions within the firm exceeds the costs of carrying out the same transactions through the market or in another firm.⁶⁰

The transaction, as the basic unit of analysis, occurs when a good or service is transferred across a technologically separable interface⁶¹ and is mediated by different governance structures in different economic organisations. Since this mediation causes costs in the economic systems, transaction costs can therefore be defined as the costs for running the (respective) economic system.⁶² Transaction costs economics views all transactions in contractual terms, independent whether they are governed by the market or by other economic organisations, especially firms, in order to facilitate a comparative analysis. Transaction costs are therefore seen in all possible economic organisations as costs related to a contract which may be concluded and executed in the market or within the firm.⁶³ These costs can be divided into the ex ante costs of drafting,

⁵⁹ Williamson, "The Logic of Economic Organization", 4 *Journal of Law, Economics & Organization* (1988), p. 66; id. (1985), supra note 47, p. 273.

⁶⁰ Coase (1937), supra note 46, p. 394ff.; id., "The Nature of the Firm: Meaning", in Williamson/Winter (ed.), *The Nature of the Firm - Origins, Evolutions, and Developments* (1991), p.48.

⁶¹ For the definition of transaction see Williamson, "The Economic Analysis of Institutions and Organizations - in General and with Respect to Country Studies", *OECD Working Paper* No. 133 (1993), p.56: Glossary: "Transaction".

⁶² Coase (1937), supra note 46, p. 390ff.

⁶³ Williamson (1985), supra note 47, p. 20. See, however, also id., "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives", 36 *Administrative Science Quarterly* (1991), p. 271-276, where the firm is no longer viewed only as a nexus of contracts and it is argued that each generic form to govern transactions needs to be supported by a different kind of contract law. However, the opinion that a transaction is governed by a contract also within firms is not retracted, therefore it is not felt that an organisation may be a relationship which is completely different from that based on a "market contract" - whereby the organisation, as a company, may also be based on an initial contract. Critical in this respect also Fitzroy/Kay, "The Corporation in an Uncertain World: Competition, Efficiency, and Governance", Sugarman/Teubner (eds.), *Regulating Corporate Groups in Europe* (1990), p. 162 and Teubner (1989), supra note 31, p. 155ff. Critical of the broad definition of transaction costs, which is equally applicable for transactions organized across the market and those organized within a firm, as making the transaction costs theory too vague, Demsetz, "The Theory of the Firm Revisited", in Williamson/Winter (eds.), *The Nature of the Firm: Origin, Evolution, and Development* (1991), p. 161ff.

negotiating, and safeguarding an agreement, as well as to the ex post costs of maladaptation and adjustment which arise when contract execution is misaligned as a result of gaps, omissions, and unanticipated disturbances.⁶⁴

The concrete goal of transaction costs economics is to align transactions, which have different attributes, with different governance structures, which have different costs and competencies, in a discriminating way to economise transaction costs. Accordingly, the defining attributes for transactions need to be identified, and competencies (incentive and adaptive attributes) of alternative governance structures need to be described.⁶⁵

b. Behavioural Assumptions and Distinguishing Dimensions of Transactions

As the costs of a transaction vary with the characteristics of the human-decision makers and the properties of the transaction, transaction cost economics has first to define its behavioural assumptions and the critical dimensions of the transaction. The same set of factors which are crucial for determining the cost of a market transaction apply to firms, although somewhat differently. Transaction cost economics tries to see "man as he is", therefore it takes bounded rationality and opportunism as assumptions about human behaviour. As a cognitive assumption, bounded rationality refers to human behaviour that is intendedly rational, but only limitedly so.⁶⁶ The limits of rationality are reached only under conditions of uncertainty and/or complexity. Under these conditions all complex, especially long-term contracts, are unavoidably incomplete.⁶⁷ Opportunism extends the conventional assumption that economic agents are guided by considerations

He instead differentiates between transaction and management costs (and production costs) which cannot be clearly distinguished in reality and have all to be taken into account to define the boundaries on one side of which resources are managed within a firm and on the other side of which are price directed across markets.

⁶⁴ Williamson (1985), *supra* note 47, p. 20f.; *id.* (1993), *supra* note 61, p. 56: Glossary: "Transaction Costs"; with another discrimination between coordination and motivation costs, Milgrom/Roberts (1992), *supra* note 35, p. 29f.

⁶⁵ Williamson (1985), *supra* note 47, p. 18, 41.

⁶⁶ Simon, *Administrative Behavior*, 2nd. ed. (1957), p. XXIV; taken up by Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975), p. 21f.

⁶⁷ Williamson (1988), *supra* note 59, p. 68.

of self-interest, as it involves self-interest seeking with guile. This refers to incomplete or distorted informational disclosure, also to outright lying and cheating if the actors think it serves their own interest. Promises to behave responsibly that are unsupported by credible commitments will not, therefore, be reliably discharged. Differences between societies in socialisation can have an impact on both opportunism and bounded rationality, but do not ensure that this human behaviour disappears.⁶⁸

Furthermore, it is important to identify the critical dimensions with respect to which transactions differ; the most critical dimension for describing transactions and aligning them with the different governance structures is the condition of asset specificity.⁶⁹ Parties to a transaction which is supported by nontrivial investments in durable, transaction-specific human or physical assets are effectively operating in a bilateral trading relation with one another and become bilaterally dependent. Asset specificity refers to the degree to which assets can be redeployed to alternative uses and by alternative users without any sacrifice of productive value. It is a critical factor because competition is eliminated due to the transaction specific investment. In the same way, the intertemporal government of contractual relation is complicated. A condition with effective competition at the outset can be effectively transformed into one of bilateral supply thereafter because rivals cannot be presumed to operate on an equal basis once the substantial investment in transaction specific assets are put in place. The relationship of seller and buyer has been transformed into a bilateral monopoly, because of asset specificity and transaction-specific savings. As a result, a governance structure which attenuates opportunism and otherwise infuses confidence is needed.⁷⁰

These three factors have profound implications for choosing between alternative contractual relationships. If one of the behavioural assumptions -bounded

⁶⁸ Williamson (1985), *supra* note 47, p. 47f., 68; *id.* (1993), *supra* note 61, p. 11, 15f.

⁶⁹ Williamson (1985), *supra* note 47, p. 30; the other important dimensions for the characterising transactions are the frequency with which they occur (*ibid.*, p.60f.) and the degree and type of uncertainty to which they are subject (*ibid.*, p.56-59). Milgrom/Roberts (1992), *supra* note 35, p.32f., define two other dimensions of transactions, namely difficulty of performance measurement and connectedness to other transactions.

⁷⁰ Williamson (1985), *supra* note 47, p. 53f., 61-63; *id.* (1988), *supra* note 59, p. 77f.

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rationality and opportunism- were absent, a solution could be found because it could be based on comprehensive planning and the efficacy of court adjudication (in the case of the absence of bounded rationality), or on the promise to fulfil the contract efficiently and to seek only fair returns at contract renewal (in the case of the absence of opportunism). In the absence of asset specificity in a situation, the competition of fully contestable markets can be relied on.⁷¹ If the factors are united, each of the three devices fails. In this case the assessment of alternative organisational modes which deal with this behaviour in a better way than the market and serve therefore gains of efficiency, becomes necessary. As one solution, internal organisation may be proposed because it permits economies to be realized in initial contracting, monitoring, and building up confidence⁷².

c. Dimensionalizing Governance and Discriminating Alignment

For transaction costs economics it remains to define the attributes of markets and firms (hierarchies) as different governance structures and to assign them to the different kinds of transactions. Most characteristic of market transactions⁷³ is that they take place between autonomous traders. For them, the market is a highly flexible instrument to adapt their actions on the information which is contained in the price. The market offers a high incentive intensity, and changes in efforts expended have an immediate effect on the compensation of the parties.

The main feature of internal organisation, on the other hand, is the common ownership which spans both sides of the transaction so that the transaction -when removed from the market and organised within the firm- is subject to an authority relation.⁷⁴ This authority relation can decide problems between the different sides of

⁷¹ Williamson (1985), *supra* note 47, p. 30-32.

⁷² Williamson (1975), *supra* note 66, p. 21-27; *id.* (1988), *supra* note 59, p. 68.

⁷³ For the characteristics of market transactions, see Williamson (1985), *supra* note 47, p. 73f.; *id.* (1991), *supra* note 63, p. 271-279; *id.* (1981), *supra* note 66, p. 1547f.

⁷⁴ See Williamson (1985), *supra* note 47, p. 75-78; *id.* (1991), *supra* note 63, p. 274-280. It is important to note that for internal organisation an authority relationship is necessary, mere unified ownership is not sufficient to evoke this effect, see *id.* (1975), *supra* note 61, p. 95-102. In Williamson's theory there is no comprehensive treatment of authority, direction, and organisation, see critical in this regard, Fitzroy/Kay (1990), *supra* note 63, p. 162f.; Teubner (1989), *supra* note 31, p. 155-157.

the transaction definitely, invoke fiat in the case of disputes, and can adapt the different sides to each other by consequential decision-making. The relationship in internal organisation is characterised by more cooperation and normally by a greater confidence, and is furthered by the lower incentive intensity in a firm. Instead of the higher incentive intensity of the market, unwanted side effects can be checked as hierarchy can exercise administrative control and has its own incentives. The employees of the firm, especially the managers, are subject to an internal auditing and evaluation procedure.⁷⁵ Bureaucratic costs are the price which the building of the hierarchy causes. Moreover, since the hierarchy frees the units from the strict control of the market and its high incentive intensity, this may lead to losses of efficiency.⁷⁶

Especially due to the bureaucratic costs which arise with building a hierarchy, it is plausible to assume that transactions will be organised by markets unless market exchange gives rise to serious transaction costs. Markets can also exhaust more fully economies of scale and scope and can aggregate uncorrelated demand in the case of nonspecific transactions. Therefore, the market is appropriate for nonspecific transactions of both the occasional and recurrent kinds.⁷⁷

As asset specificity for governing recurrent transactions deepens and a bilateral dependency results, internal organisation enjoys advantages over market contracting with regard both to contract-writing and contract-execution stages.⁷⁸ For safeguarding their specific assets both parties of the transaction will insist upon contractual safeguards, which are costly to negotiate. During the stage of executing, the contract disturbances may appear, especially in case of necessarily incomplete long-term contracts, and a need for adaptations arises. Among autonomous traders costly self-interested bargaining or even court adjudication is likely to take place. The authority in internal organisation, on the other hand, allows adaptations to be made in a

⁷⁵ See Williamson (1975), *supra* note 66, p.35f.

⁷⁶ These reasons are mainly responsible for the limits of firm co-ordination, Williamson (1985), *supra* note 47, ch.6, p.131-162; *id.* (1988), *supra* note 59, p.80-83.

⁷⁷ Williamson (1985), *supra* note 47, p.73f.; *id.* (1981), *supra* note 27, p.1547f.

⁷⁸ For the advantages of internal organisation, see Williamson (1981), *supra* note 27, p.1548f.; *id.* (1991), *supra* note 63, p.278f.; *id.* (1985), *supra* note 47, p.76-80.

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consequential way, without the need to consult, complete, or revise interfirm agreements - this makes a faster adaptation on the environment possible. Where a single ownership entity spans both sides of the transactions, a presumption of joint profit maximization is warranted. Furthermore, the authority can handle internal relations, especially disputes, more appropriately than arbitrators or courts, as it has easier and more complete access to the relevant information.

To sum up, the market is apt to govern nonspecific occasional or recurrent transactions whereas internal organisation is the more efficient means for recurrent and highly specific transactions. Referring back to the topic of this study, by substituting a market relationship for internal organisation in the above described conditions economies on transaction costs are possible, therefore joining companies together in a group relationship would lead to a more efficient resource allocation. Between markets and hierarchies as polar modes there are hybrid modes which can be the more efficient governance structures for transactions whose attributes lie inbetween.⁷⁹ These modes will not be analysed as this study is only interested in how far a submitting the group companies to a hierarchical decision-making process can be more efficient than a market relation between them.

3. Implications of Information for the Choice of the Organisation

Some insights for the choice between markets and firms as different means to allocate resources may be given by their ways of dealing with information. Information and knowledge⁸⁰ are fragmented among members of society; there is no knowledge shared by all of them and no member of society can possess all existing knowledge and information.⁸¹ Economically relevant information and knowledge is both localized and dispersed throughout the whole economy. This fragmentation of knowledge forms a key problem in allocating resources for their most efficient use and in adapting it to

⁷⁹ For a complete survey, Williamson (1991), *supra* note 63, p. 269ff.

⁸⁰ Knowledge will hereinafter be used to indicate stored and applied information.

⁸¹ See Hayek, "The Use of Knowledge in Society", 35 *American Economic Review* (1945), p. 519f.

changing circumstances. The allocation of resources to its most efficient use depends on planning; the question, thus, is how an allocation of resources can be performed if the knowledge which is necessary for the planning is dispersed among separate individuals. The problem then is to find a way of utilizing knowledge which is initially dispersed among the individuals, in order to build an efficient plan for the whole system and to communicate to the individuals the parts of the plan which are relevant for them and on which they can base their plans and decisions. The question with regard to markets and organisations in this respect is how they can deal with the fragmented information and knowledge, and which system -under which circumstances- leads to more efficient economic activity and to a more efficient allocation of resources. The efficiency of the procedure depends especially on whether the system is always able to reach an efficient decision, how much information has to be transmitted for efficient planning, how precisely and rapidly the information is transferred, which system can make the fullest use of existing information, and how changes are communicated so that the system can be adapted to them.

Also with regard to informational aspects, the market is a very decentralised system for allocating resources. The decisions about the use of resources are left to individual consumers and productive units with whom the local knowledge of preferences, endowments, and production technology and possibilities resides. The additional information which is needed for these individuals to adjust their plans with those of others and to fit their decisions into the whole system is conveyed by prices. The (changing) prices -resulting from changes in offer and demand- coordinate the resources in such a way that an efficient allocation is achieved as prices in competitive markets express the value of a good in its best use.⁸² The local knowledge of consumers and producers does not have to be transmitted in detail to a central planning office - which would then coordinate resources with respect to the information transmitted in order to achieve an efficient allocation of resources so that only the relatively small amount of information represented by prices and offers to buy and sell is transmitted. The price system also communicates by changes in relative prices the

⁸² See Posner (1992), *supra* note 28, p. 13f.

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economically relevant information about changes in reality, expressed in changes of offer and demand. Everyone can adjust their plans to these changes and in this way coordinate them with others. In this way, the price system leads to an efficient allocation of resources again, and the coordination of resources is achieved automatically.⁸³

In situations in which no other information than prices is needed for an efficient resource allocation (for different circumstances see below) the market therefore in general permits an efficient allocation of resources with a minimum of information transmitted under full exploitation of local information and knowledge. It is therefore extraordinarily efficient for communicating the relevant information. As changes in the economy are immediately translated into changes in the relative prices, the market is also an effective means to rapidly adapt to a changing reality.

Organisations deal with information in a different way to that of the market. Organisations, especially firms, can be viewed as repositories, with specialized stocks of productive information and knowledge.⁸⁴ Business firms are organisations which know how to do things, and they can accumulate common information about the nature of technology, the product involved, about the necessary resources and capabilities, and so on.⁸⁵ In reality, it is mostly not difficult to identify and distinguish the areas of competence of most of the largest corporations, since a firm normally has a specific range of productive knowledge.⁸⁶ Above mentioned examples demonstrating the knowledge of firms are the exploitations of economies of scale which are based on learning curve effects and a general greater expertise resulting from an increased

⁸³ Hayek, *ibid.*, p. 519ff.

⁸⁴ Demsetz (1991), *supra* note 63, p. 171-174; Winter, "On Coase, Competence, and the Corporation", in Williamson/Winter (eds.), *The Nature of the Firm - Origin, Evolution, and Development* (1991), p. 189-191; Favereau, "Marchés internes, marchés externes", *Revue économique* 1989, p. 297; Zeleny, Milan, "Management Support Systems: Towards Integrated Knowledge Management", *7 Human Systems Management* (1987), p. 68.

⁸⁵ Imai/Itami, "Organization and Market Interpenetration", *2 International Journal of Industrial Organization* (1984), p. 298f.

⁸⁶ As knowledge and information is costly to create and to maintain the firm has knowledge only in a limited field, this limited special knowledge also defines the boundaries of the firm, see Demsetz (1991), *supra* note 66, p. 173.



number of goods produced and the development of core competencies, together with the generalized expertise of firms to design and to market a new product in a related set of markets or to use a set of related technologies.⁸⁷ This productive information and knowledge is not merely an economic contrivance of the individuals currently associated with the firm, but is established in processes and routines while individual human members come and go. Firms can therefore store more information than one person can possess over a longer period of time and perform this function largely by extending in time the association of inputs, especially human service inputs, with the firm.⁸⁸

Moreover, organisations are also capable of bringing new information into the organisation.⁸⁹ New information can be produced in the organisation itself by its members or can come from outside, in the case of firms, especially from the market.⁹⁰ The new knowledge is acquired only on the basis of the already existing knowledge and is connected with it; innovation is easier for the firm in areas where it already has some degree of relevant knowledge. By integrating new knowledge, the organisation is also able to adapt to a changing world.

The already-existing knowledge in the organisation can be the basis for a more efficient procedure for the coordination of resources than the market. First, processes and routines developed in the firm can coordinate the activities of different people in the firm very closely without the need for an always new coordination.⁹¹ Second, an active coordination of resources and activities may be more efficiently performed by the firm than by the market. In the markets, the resources are allocated by using (the information included in) prices; in the firm, instead, the coordination of resources and activities is achieved by hierarchical decision-making or cooperation/communication between the involved members/parts of the firm. The organisational coordination of

⁸⁷ See Milgrom/Roberts (1992), *supra* note 35, p. 106f.

⁸⁸ Winter (1991), *supra* note 84, p. 190f.

⁸⁹ Winter, *ibid.*, p. 189-191; Ladeur, *Postmoderne Rechtslehre* (1992), p. 196ff.

⁹⁰ See Nonaka, "Creating Organizational Order Out of Chaos: Self-Renewal in Japanese Firms", 30 *California Management Review* (1988), p. 59-62.

⁹¹ Milgrom/Roberts (1992), *supra* note 35, p. 92.

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resources can perform especially better if there is already some specialized knowledge inherent in the firm for the best solution of the particular resource allocation problem, and slight failures in achieving the right coordination can cause great costs. Among others, these can be resource allocation problems in which it is known in advance that a very precise coordination of resources or activities in time or in another respect is necessary or that there is only one person or unit needed to fulfil a particular task.⁹²

Theoretically, the price system could also be used to coordinate resources in such situations but as it does not exploit the knowledge which already exists, it leads to unreasonable information demands and works very slowly. Moreover, it may be impossible to obtain the relevant information, in order to determine the right prices which coordinate the resources in the required way. In such cases, the coordination by prices can lead to high costs of asynchronous behaviour or a duplication of activities. A coordinator who takes advantage of special knowledge inherent in the organisation about the problem can drastically reduce the amount of information required and reduce the costs of errors associated with more indirect coordination methods as prices.⁹³ Therefore, the coordination of resources within an organisation by its generic coordinative means of direction, decision, and cooperation may be more efficient than that of the market. The inherent knowledge of the organisation can be exploited for the best solution of a resource allocation problem and closer coordination can be achieved.⁹⁴

For other resource allocation problems more information is also needed than the market delivers by changing prices. If there are increasing returns to scale, information is needed in order to determine the quantity which the market will accept, which often cannot be determined with regard to the price as there may be no prices at which supply is equal to demand.⁹⁵ If an optimal decision cannot be based on local knowledge and on the information conveyed by prices alone, external information is

⁹² See the for explanation in detail Milgrom/Roberts (1992), *supra* note 35, p. 91-93.

⁹³ Milgrom/Roberts, *ibid.*, p. 103-106.

⁹⁴ cf. Demsetz (1991), *supra* note 63, p. 172.

⁹⁵ For a detailed explanation see Milgram/Roberts (1992), *supra* note 35, p. 74f., 99f.

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needed. For these decisions, too, organisations may help to gather the necessary information and to store it so that it is available -at least partly- for future opportunities.⁹⁶

The storing and producing of information in the organisation marks the great difference with respect to the market, which generates and transmits information about the best use of resources only at a certain point of time by the means of (changing) prices.⁹⁷ The advantage of this normally lies in its ability to adapt immediately to changes in the economy by changes in relative prices and to induce a rapid change of individuals by transferring this information rapidly. Organisations can solve resource allocation problems for which knowledge about the best solution is required on the basis of the knowledge inherent within them and can achieve closer coordination. They are less flexible than the market in adapting to rapid change; nevertheless, they are also able to change by creating and integrating new knowledge and combining it with what already exists. The market as a very decentralised resource allocation mechanism has the general advantage that only a very little information has to be transmitted, while the firm performs a more centralized mechanism which is more appropriate for the above-described circumstances. However, how centralised or decentralised the decision-making mechanism in a firm is depends on its internal structure; this question will be treated below. Thus, by submitting different companies to a hierarchical decision-making process the information and knowledge of the different companies can be combined very closely by organisational means so that a much larger basis of existing knowledge is created for decisions about the allocation of resources in the future.

4. Results for the Functions of an Enterprise

Through these explanations the functions of the market which the firm can take over for reasons of efficiency can be described and justified. The main forms in which a firm takes over functions from the market are those of vertical and horizontal integration. These two developments show how a firm supersedes the market mechanism by

⁹⁶ Milgrom/Roberts, *ibid.*, p. 92f., 113.

⁹⁷ cf. Favereau (1989), *supra* note 84, p. 298f.



subordinating functions to administrative decision-making. By taking over the functions of the market in this way, the modern business enterprise began to emerge in the last century, and has remained the dominant form of business organisation until today.⁹⁸ These fields are also the most important areas for cooperation between companies in a group.

Another form of combination of different units in an enterprise is the conglomerate. Its advantages are often felt to be a puzzle in the economic literature. As the units of the conglomerate are active in unrelated fields of business, the advantages of firm coordination can only appear with regard to the inputs, especially capital. However, it seems likely to assume that such inputs can be more efficiently coordinated by the market.⁹⁹ As the conglomerate does not seem to show the above- stated advantages of firm over market coordination, and a strong coordination of its different units does not seem to be necessary, the problems which are posed by the coordination of companies in a group form also do not appear to a significant extent. Hence, this form will not be dealt with.

The various functions which the firm internalises by vertical integration can still be seen in the structure of the firm as it builds various units for different functions. These units are subordinated to a managerial hierarchy, which coordinates and controls the functions instead of the market; and frequently for each function a special department of the enterprise is established.¹⁰⁰ A similar situation for groups of companies is common, and the companies are coordinated as the different units of the the enterprise.

Taking the production unit of an enterprise as the starting point, a very common

⁹⁸ See Chandler (1977), *supra* note 57, p. 376.

⁹⁹ Sceptical about the advantages of the conglomerate form, see Kallfass (1991), *supra* note 16, p. 27; for a positive approach which explains the advantages of the conglomerate by the better information which inside managers have about the different parts of such an enterprise in comparison to the fragmentary information of the capital market, see Williamson (1975), *supra* note 66, p. 158-162.

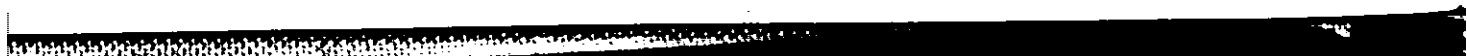
¹⁰⁰ For the quintessence of the structure of the modern business enterprise from a historical view see Chandler (1977), *supra* note 57, p. 287-289. Descriptions of firms in different branches p.289-304; summarized in Chandler (1990), *supra* note 51, p. 14.

step for an enterprise is to integrate forwards into marketing and distribution, and to form a sales department.¹⁰¹ Independent sales organisations can enjoy economies of scale and scope together with specialized knowledge as they handle the products of different manufacturers and different product lines, and are specialized in their sales activity. However, in modern economies, firms often offer highly specialized products. The advantage of the independent sales organisation has diminished as these products need specific investments, particularly specialised storage and transportation facilities and specialised skills in selling, installing, and maintaining the product. If the independent intermediary makes these product-specific investments, its ability to exploit economies of scale and scope is reduced and transaction costs are increased due to asset specificity. An integrated sales force allows for closer coordination and a better adjustment to the specific product. The special knowledge of an internal sales force can also be utilized to report back effectively on customer reaction, needs and suggestions; the additional information which cannot be obtained only by market prices is especially important in order to obtain and hold a market share large enough to assure the economies of scale in production. This information helps the enterprise to build core competencies in this field. Moreover, internal organisation can provide for better control, by that is able to protect against externalities and to provide for weaker incentives which are adequate if it is difficult to evaluate performance and nonselling activities.

The reasons for the enterprise to integrate backwards by building a purchasing organisation to take the place of the commercial intermediaries or by manufacturing its own inputs are fairly similar.¹⁰² The advantages of scale and scope of the independent suppliers are reduced when the necessary inputs for the product require highly specific investments, which would increase transaction costs. Planning for specialized products in an integrated organisation entails consultation between those who sell the product, those who make it, and those who supply parts or systems for it. Together they can

¹⁰¹ cf. for the reasons for forward integration, Chandler (1990), *supra* note 51, p. 28-31; Williamson (1985), *supra* note 47, p. 105-114; Milgrom/Roberts (1992), *supra* note 35, p. 552ff.

¹⁰² For the reasons for backward integration see Chandler, *ibid.*, p. 31; Williamson (1985), *supra* note 47, p. 114-120; Milgrom/Roberts (1992), *supra* note 35, p. 552ff.



achieve a close coordination and can make use of the necessary knowledge from all the fields involved. The internal organisation may also allow for more precisely scheduled flows to the processing plants. Any further backward integration seems to be more due to strategic purposes.

Another important step for business enterprises is the integration of research&development activity and the installation of a department for it. Research&development activity is one of the most significant in those enterprises operating in technologically advanced industry. As most research&development activity is product-specific, possible economies of scale and scope by independent research firms are diminished. Necessary product-specific skills and facilities increase asset specificity and therefore transaction costs. Furthermore, research&development for a special product line needs close coordination between marketing, plant, and laboratory personnel and the facilities handling the product. The knowledge built up by the development of new products in the field in which the firm is active belongs to the core competencies of the firm, and it is on this basis that the firm can decide upon the allocation of resources for new projects and for the future activity of the firm.¹⁰³

The firm mostly integrates other activities such as traffic, engineering, legal services, real estate, personnel, and public relations if the volume of these is very high; if they are product-specific or especially necessary for running an enterprise, such as finance and accounting.¹⁰⁴

Horizontal integration, the entering into new but related fields of business or the acquisition or merger of enterprises producing competitive products, provides another opportunity for the enterprise to grow. Horizontal combination can serve gains of efficiency by a better exploitation of economies of scale and scope (especially in production and distribution, less in other fields, e.g., in mere common financing)¹⁰⁵

¹⁰³ See for the integration of research&development activity, Chandler (1990), *supra* note 51, p. 32f. For the central importance of research&development for the future of the firm and its future competitiveness see Monopolkommission, *Hauptgutachten VIII* (1988/89), note 935.

¹⁰⁴ See Chandler, *ibid.*, p. 33.

¹⁰⁵ Bühner/Weinberger (1991), *supra* note 52, p. 198f.

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but often the incentive is to gain a more effective control of output, price and markets. Long-term viability of mergers and acquisitions is generally attained only when a centralised administrative control is quickly established over the merged or acquired firms and then the facilities and personnel are rationalised to better exploit the actual economies of scale and scope. If, instead, the acquired or merged firms continue to operate autonomously, as before, the enlarged enterprise remains little more than a federation of firms and the resulting cost advantages are minimal.¹⁰⁶ An important horizontal boundary of the firm, i.e. the fields in which it has special expertise, form its core competencies, as it is much more difficult for the firm to move into fields where it does not already possess relevant knowledge. Other reasons for a limited horizontal scope of the firm are the increasing coordination costs and greater difficulty of managing larger firms.¹⁰⁷

Through the internal organisation of vertical functions and horizontal activities in an enterprise, resources can be more efficiently used than by market coordination. In order to do so managers have to coordinate, monitor, and plan for the business in the different units of the enterprise and in this way substitute for the market. By performing effectively the two basic functions of management -coordinating and monitoring of current activity, and allocation of resources for the future¹⁰⁸- managers can make more efficient use of resources than the market, and can exploit economies of scale and scope, economies of transaction costs, as well as taking more efficient decisions for the allocation of resources on the basis of the knowledge inherent to the firm. The feature of the group structure lies in superseding the market relationship between the member companies by the group management, therefore the group can exploit the advantages of internal direction and the direction of the companies by the group management can be

¹⁰⁶ See for the historical evidence of these developments, Chandler (1977), *supra* note 57, p. 315-339; summarised by Chandler (1990), *supra* note 57, p.37. A good example is also the cooperation of the insurance companies *Colonia AG* and *Nordstern AG*, which were until 1991 under common ownership, but did not coordinate their activities closely. Now as the administrative functions are merged and the products are harmonised, savings of 150 million DM per year are expected, see *FAZ* from 16 March 1994, p. 23.

¹⁰⁷ See Milgrom/Roberts (1992), *supra* note 35, p. 570-572; Williamson (1985), *supra* note 47, ch. 6, p. 131-163.

¹⁰⁸ See for the basic functions of management Chandler (1977), *supra* note 57, p. 450, for the result of management coordination *ibid.*, p. 364.

more efficient than a market relationship between them would be.

II. Internal Organisation of an Enterprise

Gains of efficiency can be reached by the coordination of resources within a firm, as shown above, but removing the coordination from the market does not guarantee that the activity will be efficiently organised thereafter; instead, the problem is transformed into one of organisation and management. Bounded rationality and opportunism are also present in the firm, and the problems presented by both vary with changes in internal organisation.¹⁰⁹ Therefore, an analysis of how far the internal organisation of an enterprise can serve gains of efficiency needs to be made. In doing so, it should be borne in mind that for a group the aim is to find an efficient organisation with a minimum of unified management. Therefore, the organisation of an enterprise with a minimum of direct hierarchical decision-making will be analysed.

The most efficient form for the internal organisation of large enterprises has been shown to be the multidivisional-form (M-form).¹¹⁰ It was first used at the beginning of the 1920s in the organisation of General Motors and DuPont and has since become the leading organisational form for large enterprises in the United States, while in Europe it became the most important form after 1960.¹¹¹

1. Multidivisional-form

The M-form¹¹² was developed out of the unitary structure (U-form). The U-form is

¹⁰⁹ Williamson (1981), *supra* note 27, p. 1550.

¹¹⁰ Chandler, *Strategy and Structure* (1962/1991), 17th printing, p. 382f.; *id.* (1977), *supra* note 57, p. 460ff.; Williamson (1981), *supra* note 27, p. 1555ff.; in an empirical perspective and including other factors Palmer et al., "The Economics and Politics of Structure: The Multidivisional Form and the Large U.S. Corporation", 32 *Administrative Science Quarterly* (1987), p. 25ff.

¹¹¹ Bühner, "Spartenorganisation", in Frese (ed.), *Handwörterbuch der Organisation* (1992), 3rd ed., column 2275.

¹¹² See for the description of the M-form from a historical perspective Chandler (1962/91), *supra* note 110, p. 382ff; examples of *Du Pont*, p. 104ff., and of *General Motors*, p. 133ff. From the point of view of transaction costs economics Williamson (1981), *supra* note 27, p. 1555ff; in general Milgrom/Roberts (1992), *supra* note 35, p. 79ff., 540ff.

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characterised by a centralised organisation along functional lines, each function administered by a separate department. The top decision-making unit is normally composed of the major functional departments and one or two other members without direct departmental responsibility. The middle managers in the functional departments co-ordinate and monitor the activities of the lower-level managers, who administer the enterprise's operating units.

This structure is no longer appropriate for a large and diversified enterprise which is active in several markets (multiproduct firm). The operations of such a firm are much too varied and extensive for any single group of executives to manage closely. The top management empowered to take decisions is too far removed from the action and cannot have relevant information in adequate time. Even if all the relevant information could be quickly and accurately conveyed to the head office, its volume and complexity would overwhelm the central decision-makers. Therefore, top management has neither the time nor the necessary information to fulfil its tasks in this structure, to handle both long-run, strategic, and short-run, operational administrative, activities. As they are unable to cope with the administrative and informational overload and even loose control over operative affairs, top managers try to regain control at least of the operating matters, concentrate on the more immediate problems of day-to-day operations and neglect long-term planning and appraisal. A consequence of their function as departmental specialists is that they do not judge company policy from the point of view of the enterprise of a whole, but from their specialists' point of view.¹¹³

In order to cope with these problems, comprehensive decision-making in a large organisation must involve considerable delegation of authority to lower levels of the organisation. The concept of the M-form separates strategic management from operative affairs and delegates the decision-making in the operative affairs to the management of the specific unit. An M-form enterprise is characterised by a decentralised structure with several quasi-autonomous operating divisions which are organised mainly along product or geographical lines. Each division manages its operating affairs separately with its

¹¹³ For an illustration on the example of Du Pont see Chandler (1977), *supra* note 57, p.453.

own general manager and staff; the general manager is fully responsible for the division's performance and profits. For the M-form, it is not only the decentralised structure which is important, but also the existence of a general office which consists of top managers as general executives who are assisted by a large advisory and financial staff.¹¹⁴ They are responsible for the strategic management of the enterprise as a whole, not for the day-to-day work; this includes coordinating divisional activity, engaging in strategic planning and allocating resources between the divisions, and in monitoring divisional performances.¹¹⁵

a. Effects of the M-form for the Top Management

The separation of strategic and operative management helps to solve the, especially informational, problems of the U-form. Top management is relieved from operative affairs and has the time, information, and psychological commitment for long-term planning and appraisal.¹¹⁶ As top managers are no longer specialised in working for one department, it can be presumed that they act in the interest of the enterprise as a whole and do not favour operational subgoals. The clear separation of strategic and operative activities therefore helps to overcome limits of bounded rationality and to prevent opportunistic behaviour, which can at least partly be seen in the pursuit of subgoals by departmental managers.¹¹⁷

Strategic planning and control are also facilitated by the financial and advisory staff of the strong general office in the M-form. The financial staff uses comprehensive accounting and auditing procedures to provide for a constant flow of information.¹¹⁸ This information does not encompass all the information needed for running a division but is delivered on an appropriately abstracted level so that an informational overload

¹¹⁴ In general for centralisation and decentralisation in economic activity and especially with regard to organisation, see Beuermann, "Zentralisation und Dezentralisation", in Frese (ed.), *Handwörterbuch der Organisation* (1992), 3rd. ed., column 2611ff.; Milgrom/Roberts (1992), supra note 35, p. 114.

¹¹⁵ See for these as central tasks of the general management in the M-form, Milgrom/Roberts (1992), supra note 35, p. 545.

¹¹⁶ Chandler (1962/91), supra note 110, p. 382f.

¹¹⁷ Williamson (1985), supra note 47, p. 133f.; Williamson (1981), supra note 27, p. 1555f.

¹¹⁸ Chandler (1977), supra note 57, p. 461f.

of the top management is avoided. The information allows the top management to control continually and evaluate the performance of the divisions and also makes control and long-term planning on the basis of long-term projections over years possible.¹¹⁹

The clear separation of the divisions and their responsibility for success facilitate the evaluation and control of the divisions and make it possible to ascribe success or failure to the particular division and its general manager. An incentive system for the divisional manager can thus be linked with the actual performance of the division.¹²⁰ If the divisions do not perform well, the general office can assist them with the help of the advisory staff.

The flow of the appropriate information is also needed for the allocation of resources for the future by the general management. The M-form makes it possible to simulate an internal capital market, cash flows are not automatically returned to their sources but are instead exposed to internal competition. Investment proposals of the divisions are evaluated by the general management, and it can attribute cash flows to high yield uses. As the decisions of the general management can be based on the exact flow of internal information, it may be more efficient in allocating capital than the external market.¹²¹ In the same way internal markets for facilities, personnel, and especially managers can be established.¹²²

Due to the comprehensive informational basis which does not only consist of financial data, the central office in the M-form is still able to coordinate the divisions. However, top management can only fulfil its function in the M-form if -in general- a clear separation between strategic and operative management is maintained. If the general management becomes extensively involved in operating affairs, the advantages

¹¹⁹ See Stinchcombe, *Information and Organizations* (1990), p. 117.

¹²⁰ See Schweitzer, "Profit Center", in Frese (ed.), *Handwörterbuch der Organisation* (1992), 3rd ed., column 2081; Laux/Liebermann, *Grundlagen der Organisation* (1993), 3rd ed., p. 310f.; for the incentive system see Williamson (1975), *supra* note 66, p. 147f.

¹²¹ Williamson (1975), *supra* note 61, p. 147f.

¹²² In general for the establishment of market principles within organisations Imai/Itami (1984), *supra* note 85, p. 285ff.

of the M-form can no longer be expected ("corrupted M-form").¹²³

b. Profit Centre Standing of the Divisions and Responsibilities of their Management

The divisions in the M-form have a semi-autonomous standing in the enterprise; they function as so-called profit centres. Profit centres have three significant characteristics: (1) They are separate units in the enterprise, (2) they are managed mostly in their own responsibility, and (3) are evaluated with regard to the profit the unit gains.¹²⁴ These characteristics are closely interrelated, of course; the tasks of the unit, competences of its management, and responsibility for the profit have to coincide in general.¹²⁵

Profit centres are formed by dividing the enterprise into small, manageable and clearly separate units so that success or failure can clearly be assigned to the unit.¹²⁶ They are commonly formed along (regional or product) markets as only in the case of a direct market access can they fulfil their function and be judged by their profits. Especially important is the definition of the profit centres in the enterprise; they should be formed in such a way that the interactions within a division are strong, while between divisions they should be weak so that they can be more or less self-contained.¹²⁷ Relevant interdependencies between divisions appear with regard to common resources, common markets, and the internal exchange of goods. Strong interdependencies between divisions make it more difficult to evaluate their performances since a great number of interventions distort the responsibility of the divisions and the accountability of their successes (or failures). Therefore it is easier for the divisional management to coordinate activities within a division than for the central management to coordinate activities between divisions. By reducing such

¹²³ See for an extensive discussion Williamson (1975), *supra* note 66, p. 148f.

¹²⁴ For the characteristics of a profit centre see Bleicher, *Organisation: Strategien - Strukturen - Kulturen* (1991), 2nd ed., p. 696f.; Frese, *Grundlagen der Organisation* (1993), 5th ed., p. 439f.; Schweitzer (1992) *supra* note 120, column 2078.

¹²⁵ Schweitzer, *ibid.*, column 2082.

¹²⁶ Frese, "Organisationstheorie", in *id.* (ed.), *Handwörterbuch der Organisation* (1992), 3rd ed., column 1727.

¹²⁷ Frese, *ibid.*, column 1726f.; Bühner, *Betriebswirtschaftliche Organisationslehre* (1991), 5th ed., p. 128.

interdependencies between the divisions, the central management also performs a structural coordination on them as the formation of the divisions in such a way reduces the need for operative coordination afterwards.¹²⁸

The divisional management is in principle fully responsible for its profit centre, but its autonomy is limited by the intervention of the central management. The basic principle for the assigning of management responsibilities is that the divisional management must be able to influence the factors which are decisive for its success, and as a result fields which are essential for the success of the division cannot be centralized.¹²⁹ Commonly, divisions as profit centres are administratively independent and are responsible for the production and marketing of the product or in the region in question. Furthermore, they must have free access to their supply and, in general, be able to choose whether they want to purchase their supply from other divisions or from external sources. The divisional form with the highest autonomy is called the investment center, in which the management can also decide upon investments (mostly up to a certain amount, determined by the central management) and upon short-term financing.¹³⁰ Moreover, the degree of autonomy of the division depends on the structure of the enterprise at hand, whether interdependencies between the divisions make coordination by the central management necessary, and on the size of the division, as it is too costly for small divisions to build up a complete administrative structure.¹³¹ The central management is in general limited to strategic interventions; but these interventions can also influence very strongly the business activity of the division.¹³² This shows the limits of the profit centre concept, since the success of the units can always be distorted by interventions of the central strategic management, with negative, but also positive, effect. Nevertheless, in the framework which is set by the strategic management the profit centre pursues its own business success and its own profits; to put it differently, the profit centre pursues its own interest in the (framework

¹²⁸ Bleicher (1991), supra note 124, p. 695.

¹²⁹ Bühner (1991), supra note 127, p. 128; Schweitzer (1992), supra note 120, columns 2085f.

¹³⁰ Bleicher (1991), supra note 124, p. 696f.; Weilenmann, "Dezentrale Führung: Leistungsbeurteilung und Verrechnungspreise", *Zeitschrift für Betriebswirtschaft* 59 (1989), p. 938-940.

¹³¹ See Bühner (1992), supra note 111, columns 2278f.; Frese (1993), supra note 124, p. 440-442.

¹³² Bleicher (1991), supra note 124, p. 698f.



of the) interest of the whole enterprise.

The purpose of a profit centre is for the success of its management to be measured by its profits. As the management can only be responsible for factors which it can influence the relevant profit may only include these elements. The success of a division is normally measured by the return on investment (in percent) or by residual income (after subtraction of (hypothetical) capital costs). Other factors are often added to measure the success of profit centres, such as market shares or turnover.¹³³ As the managers are assessed especially by the profits of their unit, they can be tempted to focus on a short-term perspective and to neglect the provision for long-term profits and for the survival of its division in the future.¹³⁴ Therefore, the central management has to add other criteria to assess the divisions' provision for the future or has to introduce other coordinating measures, especially by determining how much they have to spend for research&development, marketing, training of employees, environmental protection, etc..

The greatest problem in evaluating the performance of a divisional management by its profits is the fixing of prices for the exchange of goods between the divisions and between divisions and central level.¹³⁵ As these prices are the basis for the allocation of resources between divisions and for the determination of the divisions' profits they should be market prices. In this way, divisions can compete with external competitors or with other divisions to make the best offer. However, if the prices of external markets do not exist, e.g. in case of intermediary products which are normally not traded or specialised internal services, prices must be negotiated or fixed with regard to incremental or full costs. In this way, the external market is at best replaced by an internal market; but as this internal market is only simulated, the prices often do not represent the free floating of offer and demand. Hence, if the exchange of goods

¹³³ See Weilenmann (1989), *supra* note 130, p. 939ff., based on a study of 80 large Swiss groups; Bühner (1992), *supra* note 111, columns 2283f.

¹³⁴ See Schweitzer (1991), *supra* note 120, column 2084f.; Bleicher (1991), *supra* note 124, p. 697.

¹³⁵ For the problem of transfer prices in this concept, see Milgrom/Roberts (1992), *supra* note 35, p. 78-81, 548-552; Weilenmann (1989), *supra* note 130, p.945ff.; Bühner (1992), *supra* note 111, column 2283.



between divisions is not based on external market prices, the informational value of the divisions' success is much reduced; at the same time, it is difficult to direct the allocation of resources between divisions on the basis of purely internal prices formed in this way, and therefore this is often still done by means of plans.¹³⁶ Furthermore, a distortion of the success of the division makes it difficult for the general management to allocate resources between divisions on this basis and to determine whether transactions should occur within the firm or across firm boundaries.¹³⁷

c. Advantages of the Decentralised Structure

The decentralisation of decision-making and responsibility by dividing the enterprise into small manageable units with a profit centre standing has several advantages.¹³⁸

First of all, the informational problem of the large multiproduct enterprise which operates in markets with different attributes is at least mitigated. As the divisions are closer to the market, they obtain directly the necessary information for success in the market. The manager of the particular division can gain first-hand knowledge of the operations of the division, and therefore possesses the local knowledge relevant for running the division and can specialize in it. The functions which are necessary for the success of the special product in the market -e.g. engineering, production, marketing- are concentrated in the division, and the whole decision-making process can be aligned to the success of the divisional product; in the same way, a division can focus on regions. Thus, decisions are taken on the level where the relevant information resides, and does not need to be transferred to and processed on a higher level; in addition, the divisional manager can consult with the central office when this seems necessary and can take advantage of the experience and perspectives of the headquarters' staff.¹³⁹ On

¹³⁶ Very critical with regard to the function of internal prices to allocate resources between the divisions as the prices are only the result of fictitious markets, see Frese (1993), *supra* note 124, p. 442ff.; Schweitzer (1992), *supra* note 120, columns 2086f.

¹³⁷ cf. Milgrom/Roberts (1992), *supra* note 35, p. 80f.

¹³⁸ For the advantages of a decentralised divisional organisation see Schweitzer (1992), *supra* note 120, column 2081f.; Bleicher (1991), *supra* note 124, p. 697.

¹³⁹ See Stinchcombe (1990), *supra* note 119, ch.4, esp. p. 104ff., 116f.; Milgrom/Roberts (1992), *supra* note 35, p. 544f.; Schweitzer (1992), *supra* note 120, columns 2081f.

the other hand, the local knowledge of the divisional manager also makes him prepared to recognize new strategic options. Involving the division managers in the formulation of plans and strategies permits their knowledge to be used in these processes; however, the necessary detailed information for a joint strategic planning does not have to be transmitted continually.¹⁴⁰ Furthermore, since the paths of communication and information are shorter in a smaller division than in the large centralised enterprise, the divisions are more flexible and are apt to respond more rapidly to market changes and to adapt to a transforming environment.¹⁴¹

Direction and control of the parts of the enterprise are also facilitated by introducing a decentralised structure of this type. Profit centres are structurally aligned to the dominant goal of the enterprise, to earn profits, by their function in the enterprise. The repeated operative alignment by top management's instructions is replaced by a structural adaptation of the profit centre to this goal of the enterprise. This also facilitates the control of the enterprise. The profit centre and its management is first and foremost controlled by its profits, which it has to achieve in the market; therefore control by the top management with the help of hierarchical means is partially replaced by market control.¹⁴²

Divisions as profit centres also have advantages with regard to their managers. The taking over of the quasi-entrepreneurial responsibility of a division increases in general the motivation of managers, which is also furthered by the objective evaluation of their work according to the success in the market. As there is a close link between divisional success and the performance of its managers, the incentives for them can be increased and they usually participate in the success of the divisions - in a financial respect as well as regarding their career expectations. This can also be practised for the other divisional employees as in their case too the connection between their efforts and the measured performance of their (small) units is underlined.¹⁴³ Moreover, as the

¹⁴⁰ See Milgrom/Roberts (1992), *supra* note 35, p. 545.

¹⁴¹ Schweitzer (1992), *supra* note 120, column 2082.

¹⁴² cf. Eccles/White, "Firm and Market Interfaces of Profit Center Control", in Lindenberg et al., *Approaches to Social Theory* (1986), p. 204-206.

¹⁴³ Weilenmann (1989), *supra* note 130, p. 942f.; Milgrom/Roberts (1992), *supra* note 35, p. 545.

divisional managers fulfil entrepreneurial functions they are best prepared for future top managerial positions.¹⁴⁴

2. Disadvantages of Loose Forms of Organisations

The advantages of the M-form can be perceived not in organisational forms which are only loose, i.e. those in which the central office is not constantly involved in management activity. Such loose organisational forms are conglomerates or holding companies.¹⁴⁵ In these forms the divisions enjoy a high degree of autonomy, the general office is small and has no advisory staff. They are unable to achieve economies of scale and scope with regard to more than one division as they have no function in the central office for this purpose. For the same reason a coordination of the divisions does not take place, since the divisions formulate their strategies completely on their own. The central office exercises control only regarding financial affairs, not with respect to operating activities; they are far less effective in monitoring and evaluating divisional performance and in taking actions to improve it and to assist weak divisions as they have no advisory staff.¹⁴⁶ A transfer of knowledge between the divisions and between the central office and the divisions does not take place as the central office does not possess specialized knowledge which is interesting for the divisions (with the exception, perhaps, of financial knowledge) and there are no links between the divisions which -in a conglomerate- are active in very diverse fields.

These forms are more appropriate for pure financial investments; their advantage is that they can withdraw easily from an existing investment. Thus, such loose organisational forms with highly autonomous divisions and a general office which is not involved in strategic control do not lead to gains of efficiency. They seem to have no advantage over an arrangement in which the various divisions are fully

¹⁴⁴ Chandler (1977), *supra* note 57, p. 180f., for such effects of a decentralised structure on managers in an example of the American railroads.

¹⁴⁵ cf. Williamson (1975), *supra* note 66, p. 143f.; Chandler (1977), *supra* note 57, p. 481f.; in Williamson's terms the conglomerate is not a loose form of organisation but a diversified kind of M-form enterprise, see Williamson (1981), *supra* note 27, p. 1557-1560.

¹⁴⁶ Chandler (1977), *supra* note 57, p. 481f.; for the disadvantages of only loose forms of organisations in the American railroads in the 19th century, see Chandler, *ibid.*, p. 182f.

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independent enterprises and are controlled by the capital market.¹⁴⁷

3. Conclusion

The M-form enterprise can profit from all the advantages which an internal organisation possesses in comparison to market coordination of resources and avoids at the same time the disadvantages of a centralized organisation which is no longer able to control and direct large enterprises which are diversified in related areas and over several markets. The advantage over market coordination presupposes a strong general office which performs strategic control and planning over the divisions and "makes the enterprise a whole more than the sum of its parts".¹⁴⁸ Only with a general office can the enterprise have the advantages of firm coordination over market coordination of resources, and therefore particularly exploit economies of scale and scope, and economies on transaction costs, thereby profiting from the information given in the organisation as a whole. On the other hand, the M-form can take advantage of small, better manageable units by taking up a decentralised structure and forming divisions with a semi-autonomous standing. Their responsibilities are defined precisely so that success or failure can clearly be assigned to the division and its management; this makes the direction and the control of a large enterprise possible.

For the internal coordination and control of these units the M-form does not use only hierarchical decision-making but also establishes market mechanisms within the enterprise. It installs internal markets for capital, personnel, managers, and facilities. The internal exchange of goods is exposed to market mechanisms and competition as well; this guarantees efficient activity in all areas of the enterprise. The M-form, therefore, combines the advantages of small autonomous units with those of large integrated enterprises and combines the characteristics of hierarchical organisation and market mechanisms.

In how far this organisation can be transferred to the group of companies will be

¹⁴⁷ Williamson (1975), *supra* note 61, p. 144; Chandler (1990), *supra* note 51, p. 37.

¹⁴⁸ See Chandler (1990), *supra* note 51, p. 594.

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examined below. Nevertheless, it is already to note that the above shown advantages cannot be achieved by a mere common ownership of different companies but only if the management of the different companies is centralized to a certain extent with the consequence that for an efficient activity of the companies in a group a mere market relationship is to substitute by a hierarchical, organisational relationship. Moreover, the M-form does not establish a centralized hierarchy for the organisation of the enterprise, but delegates authority and responsibility and includes market mechanisms into the organisation. By this the M-form accomodates one of the goals of this study, to look for an organisational structure with a minimum of unified management in the group.

III. Economic Organisation of the Group

The goal of the economic organisation of a group enterprise -as in the case of any other organisation or enterprise- is to coordinate the behaviour of its members and align it to the predominant goals of a group.¹⁴⁹ The peculiarity of the group as an organisation is that its main members are the affiliated companies and not (only) individuals; therefore the main organisational problem of the group is to align the subsidiaries' behaviour to the goals of the group as a whole. The number and variety of the subsidiaries strengthens the centrifugal forces in the group as the companies are legally designed for an independent existence; this is of special importance if the economic activities of the subsidiaries are not characterised by a close relationship to the parent.¹⁵⁰ In order to avert centrifugal forces the group management -the other constituting element of the group and the institution which forms the group of companies into a uniform enterprise- has to form a strong centre and to secure the uniform direction of the group activity by a central decision-making process and a

¹⁴⁹ For the alignment of the members' behaviour to the predominant goals of the enterprise as the first goal of organisation, see Frese (1992), supra note 126, column 1707, an illustration upon the means used for aligning individuals' behaviour column 1727; Hübner, "Recht und Organisation", in Grochla (ed.), *Handwörterbuch der Organisation* (1980), 2nd ed., column 2007; for all aspects of coordination see Milgrom/Roberts (1992), supra note 35, passim, explicitly for coordination as the main task of organisations p. 25f., 49.

¹⁵⁰ Everling, "Betriebsabteilung oder Beteiligungsgesellschaft?", *Betriebswirtschaftliche Forschung und Praxis* 29 (1977), p. 283.

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central control of the enforcement of the decisions.¹⁵¹ The minimum criteria for the central management in this respect are that the subsidiaries cannot enforce their own goals in case of conflicts.¹⁵² Only in this way can the different companies be combined for the optimum benefit of the whole; and only by maintaining the attributes of firm coordination with regard to the unified management is the group able to achieve the advantages over market coordination and to reach the efficiency gains for which the resources of the member companies are unified.¹⁵³

The main goal of the group -the goal which the organisational structure must help to achieve- is to be successful in the market and to make profits by market transactions, as in case of any other capitalist enterprise.¹⁵⁴ Without profits the group will not survive over a long period of time. Therefore, it is not only short-term profits which are relevant, since it is especially important to prepare the basis for long-term profits which often may decrease short-term profits. Only this can secure the existence of the enterprise in the future, a basic goal of any enterprise. This may offer a perspective not only to pursue direct profit-related goals but also to take into account other goals which are relevant for the future of the enterprise.¹⁵⁵ Nevertheless, in order to enable the group to be successful in the market, to make profits, and thus to secure its existence in the present and future, the organisational structure of the group has to be efficient.¹⁵⁶ Therefore, on the one hand, the organisation of the group has

¹⁵¹ Everling, "Konzernführung durch eine Holdinggesellschaft", *Der Betrieb* 34 (1981), p. 2552; Scheffler (1985), supra note 10, p. 2006. See for illustration the merger of the three *Siemens* companies to the uniform *Siemens AG* in order to enable it to act in a uniform way, apud Pausenberger, "Konzerne", in Grochla/Wittmann (eds.), *Handwörterbuch der Betriebswirtschaft* (1975), 4th ed., column 2242; and the example of the *I.G.Farben*, which even after the merger could not be transformed into a centrally managed enterprise due to the lack of a strong general office, Chandler (1990), supra note 51, p. 573ff.

¹⁵² Pausenberger (1975), supra note 151, column 2235; Schruff, "Konzern", in Wittmann et al. (eds.), *Handwörterbuch der Betriebswirtschaft* (1993), 5th ed., vol. 2, column 2274.

¹⁵³ In the case of groups mostly called "synenergies", see Bühner, "Management Holding", *Die Betriebswirtschaft* 47 (1987), p. 47.

¹⁵⁴ Frese (1992), supra note 126, column 1707.

¹⁵⁵ Long-term profits to finance long-term growth as basic goals of a capitalist enterprise, see in a historical perspective Chandler (1990), supra note 51, summarised at p. 17, 594f.; as goals to achieve by internal organisation of a firm see Frese (1992), supra note 126, column 1707, 1725f.; for the relationship between profits and securing the existence of groups of companies as organisations in the future, see Scheffler (1985), supra note 10, p. 2008f. For the interpretation of an enterprise as a system of knowledge and memory in time and the danger for this function by taking only short-term interests into account, see Ladeur (1993), supra note 89, p. 203.

¹⁵⁶ Theisen (1986), supra note 18, p. 749.

to make it possible to exploit the advantages of firm-coordination of resources over market coordination and to justify the unification of the different companies' resources by that. On the other hand, the M-form concept has to be transferred to the group as it is an efficient form of internal organisation and in principle complies with the requirements of this study for only a minimum of centralized organisation.¹⁵⁷ Hence, the organisation of the group has to hold the balance between the centralizing of functions to form a uniform enterprise and the decentralisation of functions to achieve an efficient internal organisation - an organisational task which has to be fulfilled by any enterprise¹⁵⁸ and for which the group may especially be well suited.

To examine the organisation of the group the legal and economic structure of the group and its adaptation to the M-form will first be analyzed; in a second step the division of management responsibilities -between the unified group management and the subsidiaries' management- will be dealt with, and in a last step the advantages of the organisation of economic activity in the group will be discussed.

1. Organisational Structure of the Group

The organisational structure of the group is not only determined by economic organisational considerations, since it cannot take place without considering the basic legal implications.¹⁵⁹ By definition, the group consists of legally independent companies which are combined under a unified management. The first element, the legal independence and separateness of the single companies, has to be borne strictly in mind for an economic organisation of the group; the group cannot be organised as if it were a uniform enterprise without legal restrictions for the economic organisation, but economic organisation has to take into account that principally the group consists of

¹⁵⁷ See the appearing conflict of company law and group organisation and the task of this study to assume a minimum of unified management as a starting point in order to accomodate the legal concept of the company.

¹⁵⁸ cf. Bleicher, "Konzernorganisation", in Frese (ed.), *Handwörterbuch der Organisation* (1992), 3rd ed., columns 1163f.

¹⁵⁹ See Schruff (1993), supra note 157, columns 2285f.; see, however, for the advocating of a complete primacy of economic considerations for the organisation of groups in order to break legal reasoning, Theisen, "Vorüberlegungen zu einer Konzernorganisationslehre", *Die Betriebswirtschaft* 48 (1988), p. 282, 285; critical Debus, *Haftungsregelungen im Konzernrecht* (1990), p. 167 note 4.

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different companies as separate entities.

The other constituting element of the group -unified management- is less legally characterised and can be based on very different legal means.¹⁶⁰ Most commonly a group is based on shareholding or the holding of voting rights; while normally a majority is needed to control the company, often a minority is sufficient if the other shares are widespread. Groups are also often based on contracts; in Germany control contracts are allowed, in other countries, groups can be based on other contracts such as management contracts or business lease agreements. Unified management can also be performed by interlocking directorates, but mostly they are also based on shareholding. These groups all have in common that one company is subordinated to another; however, a group can also be based on a centralized management among equals. This is a very rare form in economic reality and will not be treated in this study.¹⁶¹ These legal means may have different legal consequences and restrict economic organisation in this way but mostly do not per se predetermine the exercise of unified management. With the problems which are caused by the various forms of unified management for the law and especially for the legal structure of the company, it will be dealt later.

For the economical organisation of groups, a short survey over the economic criteria to structure groups for various economic purposes will be given, and afterwards the adaptation of a company system to the M-form will be discussed.

a. Economic Types of Groups

Groups appear in economic reality in an unlimited variety of structures; thus a great number of criteria are relevant for the economic structuring of the group. Which path

¹⁶⁰ For a comprehensive survey over the possibilities of forming company systems on a comparative legal basis, including public limited companies in -among others- France, Germany, and Great Britain, see Immenga, "Company Systems and Affiliations", *International Encyclopedia of Comparative Law* (1985), vol. XIII, ch. 7, note 8-29.

¹⁶¹ From the point of view of economists there are doubts whether this form can really lead to a unified management in economic terms, see Bleicher (1992), *supra* note 158, column 1161.

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a group follows and which functions are assigned to the particular companies in a specific group depends on the goal or strategy the particular group pursues, an optimal group structure cannot be determined in general.¹⁶² Some important categories of dividing groups are described in the following in order to give an illustration for the economic use of group structures¹⁶³; it is impossible to give a comprehensive survey as an economic theory of the group does not exist.¹⁶⁴

Groups can be differentiated by the products the member companies produce. In the vertical type, the group members perform consecutive processes of production, distribution, etc. and the groups benefit from the advantages of vertical integration. The horizontally integrated group includes companies offering related products and can take advantage of horizontal integration in the different fields. The conglomerate type combines companies with heterogeneous products and may offer advantages by risk-sharing between the different activities and in the financial field.

Groups can also be divided according to the function of the parent company. This may be itself active in the product markets or may have limited its role to the holding of shares. The holding company can be divided into the mere financial holding which only exercises the normal control rights of a shareholder and the holding which performs management functions in the group. As the pure financial holding does not establish a central group management, it does not fulfil the above-defined requirements of a group.

Another criterion to categorize groups is the function which the different companies perform in the organisation, therefore the horizontal structure of the group. Companies which function as the basic units serve to fulfil concrete tasks of the

¹⁶² See for the great number of different criteria Lehmann, "Konzernorganisation", in Grochla (ed.), *Handwörterbuch der Organisation* (1980), 2nd ed., columns 1108ff.; Sigle, "Konzerngestaltungspolitik", *Betriebswirtschaftliche Forschung und Praxis* 38 (1986), p. 313.

¹⁶³ See for the different criteria for the economic organisation of groups beside the articles in the previous note Schruff (1993), *supra* note 157, columns 2277ff.; Bleicher (1992), *supra* note 158, columns 1152f., 1155ff.; id., "Gedanken zur Gestaltung der Konzernorganisation bei fortschreitender Diversifizierung", *Zeitschrift für Organisation* 1979, p. 244ff.

¹⁶⁴ Pausenberger (1975), *supra* note 151, columns 2246f.; Scheffler, "Der faktische Konzern", *Die Aktiengesellschaft* (1990), p. 174.

production or the distribution of a good, but they can also offer services or consultation for other members of the group.¹⁶⁵ The top unit is the parent company which performs the central management of the group. In between may be found intermediate units which coordinate and combine the basic units and may also be legally independent companies. Multinational groups are often organised in this way, so that intermediate companies unite their activities in particular regions.

b. Transfer of the M-form to Groups, and its Developments

The M-form structure as an efficient form of economic organisation for large enterprises is rather well-suited to groups. The affiliated companies which fulfil the basic functions in the group are the operating units of the M-form, while the parent company performs functions of the general office. The enterprise is divided into clearly separate units by having subsidiaries for particular business activities; these have a quasi natural profit centre standing. Economic tasks and responsibilities can be congruent with the legal definition of the company; the assignment of success or failure is facilitated as subsidiaries as legally independent companies are accounting units. The semi-autonomous standing of the operating units in the M-form accommodates to the legal independence of the subsidiary companies. However, if the divisions do not match with the subsidiary companies, then economic responsibility falls apart from the legally defined company borders; the economic organisation in this case does not at all accept the status of the subsidiary as a legally independent company.¹⁶⁶

A special adaptation of the M-form to groups of companies is the holding form in which the parent company is not itself active in the product market and has no operating responsibility. All operating affairs -divided with respect to markets- are carried out by different subsidiaries as legally independent companies. The parent

¹⁶⁵ Pausenberger (1975), *supra* note 151, column 2241f.; these legally independent services or consulting companies are mostly derived from former central departments of the enterprise, see

¹⁶⁶ Bühner (1992), *supra* note 111, column 2278; Schwark, "Spartenorganisation und Großunternehmen", *Zeitschrift für Handelsrecht* 142 (1978), p. 203ff.

company, however, does not limit itself to mere shareholding, as in the financial holding, but is actively involved in the strategic management of the group.¹⁶⁷ Therefore, the parent company complies with the requirements of the general management in the M-form, it is not only a loose form of organisation.¹⁶⁸ It is rather a development of the M-form which necessarily presupposes a group structure for the enterprise. The goals of the M-form, formed of smaller, more transparent units, the separation of strategic and operative management, and coming closer to the markets, seem to be strengthened by the separation of management functions among legally independent companies.¹⁶⁹ This form is mostly called "management" or "strategic holding" in the literature.¹⁷⁰

The division of the parent company into (mostly wholly owned) subsidiaries has become widespread among medium-size¹⁷¹ and large enterprises in Germany in recent years.¹⁷² For the transformation of enterprises into this kind of structure great

¹⁶⁷ See for the varied possibilities of structuring such a holding Keller, "Effizienz- und Effektivitätskriterien einer Unternehmenssteuerung mit dezentralen Holdingstrukturen", *Betriebswirtschaftliche Forschung und Praxis* 44 (1992), p. 16ff.; Dunsch, "Schnellboote und träge Tanker", *FAZ* from 13 June 1994, p. 13.

¹⁶⁸ See for this form Everling, "Konzernführung durch eine Holdinggesellschaft", *Der Betrieb* 34 (1981), p. 2549ff.; Bühner (1987), supra note 153, p. 40ff.; Keller, "Einrichtung einer Holding: Bisherige Erfahrungen und neuere Entwicklungen", *Der Betrieb* 44 (1991), p. 1633ff.; id. (1992), supra note 167, p. 14ff.; Bleicher (1991), supra note 124, p. 653ff.

¹⁶⁹ See for the advantages and drawbacks of such a form Bleicher (1991), supra note 124, p. 654; Dunsch (1994), supra note 167, p. 13; see for a classification with regard to the U- and M-form Bühner, "Management-Holding", *Wirtschaftswissenschaftliches Studium* 1993, p. 158f.

¹⁷⁰ Bühner (1987), supra note 153, p. 40ff.; Keller (1992), supra note 167, p. 14f.

¹⁷¹ For the wide range of applications and especially for the wide diffusion in medium-size industry see Keller (1991), supra note 168, p. 1633f.

¹⁷² One of the first examples seems to have been *PWA AG (Papierwerke Waldhof-Aschaffenburg)* in the mid 70s, see Blaschka, "Profit Centres in gesellschaftsrechtlicher Form", *Zeitschrift für Betriebswirtschaft* 52 (1982), p. 397ff. and see the theoretical analysis of this development in the note of Drumm, "Rechtlich selbständige Geschäftsbereiche - ein allgemeines Modell?", *Zeitschrift für Betriebswirtschaft* 52 (1982), p. 404ff., who could not believe in the organisational advantage of such a model and looked for tax reasons. In the last years large numbers of the large German industry have adopted this kind of holding structure, such as *Daimler-Benz AG*, *Veba AG*, *RWE AG*, *Thyssen AG*, *Krauss-Maffei AG*, *MAN AG*, see examples apud Bühner (1987), supra note 153, p. 41f. and apud Theisen (1991), supra note 17, p. 55f. The latest examples are *Krupp AG* after its merger with *Hoesch AG*, *FAZ* from 2 December 1993, p. 24; also the steel division is to be split up into 5 legally independent companies, *FAZ* from 18 June 1994, p. 15; *Kugelfischer AG*, *FAZ* from 4 December 1994, p. 14; *Lufthansa AG*, *FAZ* from 2 February 1994, p. 14; *Grundig AG*, divided into 11 legally independent companies, *SZ* from 7 February 1994, p. 18; *Metallgesellschaft AG*, after its near winding-up, *FAZ* from 18 February 1994, p. 19; *Burda GmbH*, split up into 16 legally independent profit centres with a mere holding on the top, *FAZ* from 5 May 1994, p. 20; but also a smaller enterprise as *Schwabengarage AG*,

expenditures seem to have been laid out.¹⁷³ The reasons for the choice of this (legal) structure seem to lie only in the suitability of its economic organisation, since it does not offer tax advantages, which are otherwise normally the reason to choose a (non-standard) legal structure.¹⁷⁴ Thus, while the law provides for a structure in which there is enough room for an appropriate economic organisation of the enterprise, the economic organisation seems to adapt the form of the group with its legally independent companies for its own (economic) ends.

2. Divisions of Responsibilities

The principal problem in the organisation of a group is that of vertical structuring, the division of decision-making competences and responsibilities between the central management and the management of the affiliated companies.¹⁷⁵ The horizontal structuring, on the other hand, the assigning of tasks to the particular companies in the group, depends on the the purposes of the specific group and does not cause any particular legal problems. The basic principle for the vertical division of management responsibilities in a group is the decentralisation of management as this is appropriate for an efficient organisation and may accomodate the legal perception of the (affiliated) company.

The main criterion for the division of responsibilities between central and subsidiaries' management is the separation of strategic and operative management as in the M-form.¹⁷⁶ Strategic decisions in a group are those which are concerned with the group as a whole and are essential for its assets, financial situation, and profits. By taking these decisions the central management holds the member companies together in

with subsidiaries for such diverse activities as car selling and financial leasing, *FAZ* from 26 February 1994, p. 15; the same considerations for the organisation of the *Hoechst AG*, strict separation of strategic and operative activities, *FAZ* from 5 May 1994, p. 24.

¹⁷³ See the example of the restructuring of the *SEL AG*, for which costs of more than 100.000.000 DM are reported, apud Theisen (1992), supra note 17, p. 195.

¹⁷⁴ See Keller (1991), supra note 168, p. 1639.

¹⁷⁵ See Pausenberger (1975), supra note 151, column 2241; Schruoff (1993), supra note 152, column 2280.

¹⁷⁶ Bühner (1987), supra note 153, p. 42; Keller (1991), supra note 168, p. 1635; id. (1992), supra note 167, p. 16f.

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the group and combines their resources for an optimum benefit of the whole; these management fields cannot be delegated without endangering the group as a unified organisation.¹⁷⁷ Strategic management includes long-term planning for the whole group and the single subsidiaries, the control and coordination of the subsidiaries and is closely connected with financial management. In addition, the central office can assist the subsidiaries if necessary.¹⁷⁸ Besides this, the central office can offer services for the subsidiaries and centralize other functions if in this way economies of scale or scope can be exploited. If the parent company is itself active in the product market, its management is also responsible for the (operative) business of the parent. The subsidiary management, on the other hand, performs the operative management, according to the general principle of profit centres that they must be responsible for everything that is crucial for their profits. Nevertheless, also within the concept of decentralised management and the M-form, many different arrangements of internal organisation and divisions of management responsibilities are possible, dependent on the strategy and composition of the concrete group; however, some elements are necessary to achieve the advantages of firm coordination and some standard management instruments can be found.

a. Strategic and Financial Management

In the framework of strategic management the central management of the group -above all- has to define the strategy and goals of the group as a whole. According to these, the tasks of the particular affiliated companies are determined. This includes especially the business activities with regard to products and markets and the decisions on main investment and research areas. The strategies and goals of the subsidiaries are necessarily fixed in (at least) cooperation with them as they have better (local)

¹⁷⁷ Scheffler (1985), supra note 10, p. 2006f.; v. Werder, "Delegation im Konzern - Rechtlicher Gestaltungsspielraum und organisatorische Konsequenzen im Vergleich zur Einheitsunternehmung", *Betriebswirtschaftliche Forschung und Praxis* 41 (1989), p. 412.

¹⁷⁸ See Bühner (1991), supra note 127, p. 128; Everling (1981), supra note 168, p. 2551; Scheffler (1985), supra note 10, p. 2007; as tasks for an M-form enterprise in a historical perspective Chandler (1962/1991), supra note 110, p. 8.

information about market and technological developments in their fields.¹⁷⁹ The allotment of specific business activities to each subsidiary is also a structural coordination of theirs, since this reduces the need for coordination between the subsidiaries.¹⁸⁰ According to the strategy, the central management has to fix the standing and the management responsibilities of the subsidiaries, thus the general structure and organisation of the group. By aligning the subsidiaries to the dominant goals of the group, they can be directed as a whole and are able to achieve the efficiency advantages of internal organisation.¹⁸¹ Thereby, the affiliated companies pursue at the same time their different partial subgoals and the goals of the entire group. The subsidiaries pursue their entrepreneurial interest in the framework of the entrepreneurial interest of the group, and it is in the interest of the group that the subsidiaries as profit centres pursue their self-interest in making profits. Therefore, in normal times the interests of the subsidiaries and that of the group coincide.

One of top management's most important tasks is the allocation of resources necessary for the assigned tasks of the subsidiary. These are in particular financial resources, but also others such as personnel, facilities, information, and managers. The general management, however, is not only concerned with the allocation of resources among existing subsidiaries, but also has to check continually the portfolio of the parent and is engaged in acquisition, investment, and divestiture. It has to build up or to acquire new fields of business which are economically interesting and to dispose or to close others which are no longer suitable for the group. Only such a continuous restructuring of the group to meet changing technologies, markets, and environments can secure the survival and development of the organisation -the group- as a whole. It is therefore likely that the size and amount of subsidiaries in the portfolio of the controlling company will change in time.¹⁸²

The repeated transfer of economic and social resources which promise high

¹⁷⁹ See for these main tasks of the group management Scheffler (1985), *supra* note 10, p. 2007; Bühner (1987), *supra* note 153, p. 42f.; Bleicher (1991), *supra* note 124, p. 655f.

¹⁸⁰ Bleicher (1991), *supra* note 124, p. 695.

¹⁸¹ Bühner (1987), *supra* note 153, p. 42f.

¹⁸² Bleicher (1992), *supra* note 158, column 1154; Scheffler (1985), *supra* note 10, p. 2007f.

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yields has to be performed by the central management as only this acts in the interest of the group as a whole. The predominant goal of the group is not to guarantee the existence of a specific subsidiary but to secure the group as a whole and to maximize its success. Arising conflicts between the interests of one subsidiary and the group have to be solved in favour of the group - at least from an economic point of view. However, such sharp conflicts of interest rarely appear.¹⁸³

Closely connected with the field of strategic management is that of central financial management. As financial goals for the subsidiaries in the framework of strategic management, the group management has to determine profits or return on investment and its use. Moreover, it decides upon the financial basis of the member companies, their endowment with equity capital and their degree of indebtedness. Furthermore, the central management has to establish whether they have enough liquidity for their activities. This minimum of financial management is necessary to enforce the goals of strategic management and to perform financial planning and control in the group.¹⁸⁴

The central management also has to control whether the subsidiaries comply with the goals laid down by the strategic and financial management. As the subsidiaries have a profit centre standing, the control is mainly performed by assessing their success in the market and their profits or return on investment. If the subsidiary does not perform well, the central management has to start action and assist it so that it is able to reach the given aims.¹⁸⁵

b. Management Instruments and Degree of Centralisation

In order to achieve the above-mentioned goals and to combine the companies into a

¹⁸³ Bleicher, *ibid.*, column 1154; Scheffler (1990), *supra* note 164, p. 174; Bühner (1987), *supra* note 153, p. 42f.

¹⁸⁴ Reintges, "Finanzierungsvorgänge und finanzwirtschaftliche Dispositionen im Konzern", in Christians (ed.), *Finanzierungshandbuch* (1988), 2nd ed., p. 665; Scheffler, "Zur Problematik der Konzernleitung", in Havermann (ed.), *Festschrift für Reinhard Goerdeler* (1987), p. 475; Bühner (1987), *supra* note 153, p. 42.

¹⁸⁵ See Sigle (1986), *supra* note 162, p. 315.



group, different management devices are used and the management can often be more or less centralised.

aa. General Management Instruments

In a decentralised organisational structure with subsidiaries as profit centres are the dominant management devices are no longer instructions and general rules. Instead of this, functional coordination and cooperation in the forms of budgets, plans, programmes, and committees are used to influence the the subsidiaries' management.¹⁸⁶ In this way the strategic and financial goals which the affiliated company has to achieve are expressed. These budgets and plans are also no longer set up by the central management but they mostly come from the subsidiary's management and have only to be approved by the group management which assesses them regarding to their plausibility, their attainability, and their correspondence with the goals of the group. Very often larger investments need the consent of the central management if they have not been approved in general in the budget - as this can influence the financial situation of the whole group.¹⁸⁷ Further reaching interference with the subsidiaries' management is not suitable, as this would distort the clear-cut responsibility and the very purpose of the profit centre. Only in times when the subsidiary does not achieve the given goals or especially when it produces losses will the central management interfere more with the subsidiary; its profit centre standing steps into the background.

As well as the direction of the subsidiaries by precisely fixed goals in plans and budgets, the subsidiaries' management can be influenced by more informal arrangements.¹⁸⁸ "Suggestions" of the central management may direct the subsidiary in a certain direction, the business strategy of the subsidiary may be worked out in

¹⁸⁶ Schweitzer (1992), *supra* note 120, column 2081, 2083f.; cf. on the other hand *AktG* § 308 which only speaks of instructions and shows that it was enforced in 1965; "instructions" in this sense is now interpreted to include all forms of influence, see Emmerich/Sonnenschein, *Konzernrecht* (1993), 5th ed., p. 349f.

¹⁸⁷ See Scheffler (1985), *supra* note 10, p. 2007.

¹⁸⁸ See Everling (1981), *supra* note 168, p. 2552.

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common meetings, and such arrangements are often more institutionalized by establishing committees. Such committees can consist of members of different management levels in the group in order to produce a close link between the parent and the subsidiary. The main task of the cooperation in such committees is not the enforcement of hierarchical decisions taken by the top management, but to transfer information which is needed in addition to the number-orientated information delivered by accounting and auditing procedures (see *infra*) from subsidiaries to the parent and vice versa in order to enable the group management to monitor the subsidiaries, assess their success, and, above all, to perform the planning for the group and the subsidiaries.

Committees are also often established (by the general management) to bring the management of different subsidiaries together in order to help coordinate them, to make them work together in specific fields, and simply to further the exchange of information between subsidiaries. Such cooperation and exchange of information and knowledge is especially important in the field of research&development for technologies which are developed by one group member, but which can also be used by other subsidiaries. This seems to be one important way to realize the benefits of the group link between the companies; the central management has to install such links between the subsidiaries and further cooperation between them for an optimal benefit for the whole.¹⁸⁹

bb. Accounting and Auditing

Of overwhelming importance for this concept is a comprehensive accounting procedure as it provides for a constant flow of information between subsidiary and parent (and vice versa) and different subsidiaries. Without sufficient information the central management is not able to perform long-term planning, allocation of resources, and is especially not capable of monitoring the subsidiaries as this is done by shown profits and other figures of success. The flow of information is secured by a general accounting procedure for setting up a balance sheet, a more comprehensive accounting

¹⁸⁹ Bühner (1987), *supra* note 153, p. 46f., for this purpose *Daimler-Benz AG* has installed committees with members of different subsidiaries to exploit technological synergy effects which were expected by the consolidation of different companies in the *Daimler Benz* group.

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and auditing procedure in the form of a general information and report system, and more informal ways of transferring information (see for the last above).

As legally independent bodies, the companies of the group are (in general) obliged by law to perform an accounting procedure and to draw up a balance sheet.¹⁹⁰ The accounting procedure is not only an external duty of the subsidiary as an independent company, but in the group it is internally necessary in order to fulfil the subsidiary's function as profit centre.¹⁹¹ In the balance sheet the assets, the profitability, and the financial situation of the subsidiary are shown. Beside the obligation of each group member to draw a balance sheet for itself, the parent company mostly has to draw a consolidated group account,¹⁹² which shows the assets, the financial situation, and the profit position of the group as if it were a uniform company in order to inform the public, especially shareholders and creditors, about the financial situation of the whole group. To set up the consolidated group account, the parent has to obtain the necessary information from the subsidiaries;¹⁹³ it will also provide for an accounting procedure on a unified basis in the group as this avoids different procedures for the balance sheet of the subsidiary on the one hand and the consolidated group account on the other. This is also particularly important in order to make the balance sheets of the different group companies comparable for internal use.¹⁹⁴

As the annual balance sheets of the single companies and the information for the group account do not provide enough current information for comprehensive planning and monitoring of the group members, a more comprehensive accounting and auditing

¹⁹⁰ See for Germany *HGB* §§ 242, 264.

¹⁹¹ cf. Busse von Colbe, "Konzernrechnungswesen", in Wittmann et al. (eds.), *Handwörterbuch der Betriebswirtschaft* (1993), 5th ed., vol. 2, column 2303-2305; Schweitzer (1992), *supra* note 120, column 2085f.

¹⁹² See 7th EC-Directive for the harmonisation of company law on consolidated group accounts, 83/349/EEC - OJ EC No 193, 18.2.1983, p. 1; transferred into German law by *Bilanzrichtliniengesetz* from 1985 (BGBl. I, p. 2355); see for the German law Busse von Colbe, *ibid.*, column 2287ff.; Emmerich/Sonnenschein (1993), *supra* note 186, p. 528ff.

¹⁹³ See for Germany the legal obligation for the subsidiary to deliver the necessary information, *HGB* § 294 (3).

¹⁹⁴ Busse von Colbe (1993), *supra* note 191, column 2303-2305; Scheffler (1985), *supra* note 10, p. 2008.

procedure is usually installed in the group.¹⁹⁵ This includes data as purchases, market share, turnover, cash flow, investments, debt equity ratio and a detailed analysis of the return on investment in all parts of the subsidiaries. A particularly comprehensive and close informational link can be produced by a computer connection between the group members. This kind of information and report system performs a systematic planning operation in the group over a long period of time and simultaneously prepares data of the actual performance of the group and its member companies in relation to the goals fixed in advance. If the actual result deviates from the goals to be achieved this data is basis for analyzing the causes, giving advice, and improving the performance of the subsidiary and the group.

Such comprehensive information is not only necessary for the group management (in a highly abstract form) but also serves the management of the subsidiary to direct and to control its company, although normally for this even more detailed information is needed. Such an information and report system affects the autonomy of the subsidiary only very limitedly as it is performed on a uniform basis in the group and key criteria for planning will be defined in a uniform way in order to make the results comparable within the group.

cc. Personnel Policy

A very important element of the group management for the direction and unification of the group is the personnel policy, especially the appointment of the management for the subsidiaries.¹⁹⁶ With the appointment of a management which is able and willing to follow the "suggestions" of the central management and the general goals of the group, and by the competence of the top management to sanction non-compliance through dismissal, the group can be kept together. Through personnel policy the group management can also create a group identity among the subsidiaries' management so

¹⁹⁵ See Scheffler, "Controlling im Konzern unter Beachtung der rechtlichen Regeln für die Eigenständigkeit der konzernabhängigen juristischen Person", *Die Aktiengesellschaft* 1991, p. 256ff.; Theisen (1991), supra note 16, p. 198f.

¹⁹⁶ See for personnel policy in a group Bleicher (1991), supra note 124, p. 655f.; Bühner (1992), supra note 111, column 2281f.; Scheffler (1987), supra note 184, p. 481.

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that it is easier to align the subsidiaries to the goals of the group as a whole.¹⁹⁷ Besides this, the group management has to present a systematic policy for management trainees in order to have a sufficient reserve of qualified people for the management positions in the group. For a systematic personnel policy in some groups the central management goes further and also influences the appointment of employees below the management level.

A further means of linking the parent and the subsidiary (or different subsidiaries) is that of interlocking directorates.¹⁹⁸ A director of the parent is at the same time director of a subsidiary; this secures a constant flow of information between the parent and the subsidiary, a taking into account of the subsidiary's interest by the central management, and guarantees the enforcement of the group's policies on the affiliated company's level. Disadvantage could be that the spheres of responsibilities and interests are no longer strictly separated.

Very often the management of the parent instead performs functions of control in the subsidiary, e.g. in the two tier system the parent's directors (*Vorstand*) are members of the subsidiary's supervisory board (*Aufsichtsrat*). This solution is used in nearly every group, it keeps the functions of (operative) management and control separated, but does not produce such a close link between the group members.

dd. Financial Management

The financial management of the group is one of the primary tasks of the central management and cannot be completely delegated to subsidiaries as this would endanger the uniformity of the group structure. The financial management, however, can be more or less organisationally decentralised; this depends on the strategy of the group, e.g.

¹⁹⁷ Scheffler (1985), supra note 10, p. 2010; see the example of General Motors where at the time when the M-form was introduced strong directors of the previous more independent brands were dismissed so that the newly formed general office was able to unite the different brands as one enterprise, Chandler (1962/91), supra note 110, p. 141f.

¹⁹⁸ See v. Werder, "Vorstands-Doppelmandate im Konzern", *Die Betriebswirtschaft* 49 (1989), p. 37ff.; Bühner (1992), supra note 111, columns 2281f.; Theisen (1991), supra note 17, p. 224-229.

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normally more highly decentralised in a multinational group. As the different members of the group are financially closely linked, the financial group management often includes not only strategic tasks - as in other areas - but also operative activities.¹⁹⁹ In case of extreme decentralised financing, the central management limits itself to the above shown financial goals in the framework of strategic management, decides upon the group members' profit and its use, the group's and the single members' indebtedness, and the long-term financing. By determining the group members' profits, the central management directs the single companies, the whole group becomes manageable and monitorable. The group management also has to decide on the use of the subsidiaries' profits and to ensure that they return to the parent company as - otherwise- the parent would be unable to satisfy its shareholders and creditors and could not perform the planning procedure in such a way as to ascribe financial means to projects which promise high yields and install a quasi internal capital market.²⁰⁰ The general management fixes the group's and the single member's indebtedness (e.g. by laying down a certain debt equity ratio²⁰¹ and controlling long-term planning) in order to control and limit the risk of the group. It is absolutely necessary for financial planning and control in the group in the framework of strategic management to determine these figures so that the general management can provide for the central goals of financing, liquidity, profitability, and stability in an enterprise.²⁰²

The central management defines the equity capital of the subsidiaries and is - more or less- involved in the acquisition of credits for them.²⁰³ In a decentralised financial management the group management only takes into account a uniform banking policy and gives letters of support or formal guarantees for loans in order to improve

¹⁹⁹ See Reintges (1988), supra note 184, p. 666f.; Scheffler (1985), supra note 10, p. 2008, 2010.

²⁰⁰ For the dangers if the central management no longer receives appropriate financial means, see Keller (1992), supra note 167, p. 20f.

²⁰¹ See for this and other common rules of financing in an enterprise Albach, "Finanzierungsregeln und Kapitalstruktur der Unternehmung", in Christians (ed.), *Finanzierungshandbuch* (1988), 2nd ed., p. 599ff.

²⁰² See Scheffler (1985), supra note 10, p. 2008, 2010; Reintges (1988), supra note 184, p. 665.

²⁰³ See for the whole complex of financing in the group Theisen (1991), supra note 17, p. 315-333.

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the conditions.²⁰⁴ In a more centralised financial management the parent raises credits for the entire group and passes them on to the subsidiaries. By such centralisation of raising credits economies can be achieved as it is no longer necessary to maintain this function at the level of the subsidiaries and more favourable banking conditions can therefore be negotiated. However, in this case the entire provision for the liquidity of the subsidiaries has to be fulfilled by the parent.²⁰⁵

The financial management can be more highly centralised by the installation of a central cash management. This balances the temporal demand and surplus of liquidity by short-term loans between the single subsidiaries and helps the group to achieve economies by avoiding interests for bank loans. In its most centralized form the subsidiaries do not have their own bank accounts, but this rarely happens. If performed with the usual interest rates, this does not distort the success of subsidiaries as profit centres, but the parent has comprehensively to provide for the liquidity of the subsidiaries.²⁰⁶

For multinational groups the management of foreign exchange is particularly important in order to minimize the risks which occur for the group as a whole as a result of currency fluctuations. This is not normally centralized as the subsidiaries have to be very flexible in their reactions to currency fluctuations, e.g. in changing their prices with respect to fluctuations.²⁰⁷

All these functions do not necessarily have to be performed at the level of the parent company; in some groups there are special subsidiaries which perform the banking business for the members of the group.²⁰⁸

²⁰⁴ Schruoff (1993), supra note 152, column 2282; in an empirical study on 80 Swiss groups there was no case in which the subsidiaries' management could have decided on the raise of equity capital or of long-term capital, see Weilenmann (1989), supra note 130, p. 940, 953.

²⁰⁵ Reintges (1988), supra note 184, p. 672f. For the legal problem with regard to liquidity see Schneider, "Das Recht der Konzernfinanzierung", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* (13) 1984, p. 532ff.

²⁰⁶ Reintges (1988), supra note 184, p. 674ff.; Scheffler (1985), supra note 10, p. 2008.

²⁰⁷ Reintges, *ibid.*, p. 681-685.

²⁰⁸ Reintges, *ibid.*, p. 679-681; these so called in-house banks are often involved in providing financing or leasing services for the goods produced by other group members.

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ee. Coordination Instruments

The central management can also be responsible for the coordination of the subsidiaries' activities. The structural coordination, defining the business activity of each subsidiary in such a way that most coordinative needs can be met within the unit, has to be solved within the framework of strategic management. Continuous coordination of the subsidiaries may be needed for operative functions, e.g. research&development. Needs for coordination may especially arise with regard to the internal exchange of goods. Since the internal exchange of goods is one of the means for taking benefit of the resource combination in a group, the central office should in principle promote it. It may be difficult to fix the conditions for the internal exchange of goods, especially prices, if market prices do not exist; in this case, the necessary coordination can be performed by the central office (at best only advisory) or by the subsidiaries themselves through negotiations.²⁰⁹

c. Other Areas of Central Management

Together with the above shown (minimum) instruments of central management for keeping the member companies together in the group, the central office can take over further management, coordination, and service functions.²¹⁰

In technologically orientated groups often a central research&development department is installed in order to develop technologies which can be used in different member companies and which are not clearly related to the work of one subsidiary. Besides the development of technologies which overlap the field of one subsidiary a central department of this type can help the central management in its strategic decisions regarding new fields of technology in which it would be economically interesting to build up new business activities. A central office for production may serve

²⁰⁹ See Everling (1981), *supra* note 168, p. 2552; Theisen (1991), *supra* note 17, p. 198f.; for the different concepts for determining transfer prices see Theisen, *ibid.*, p. 333-343; Weilenmann (1989), *supra* note 130, p. 945ff.

²¹⁰ For a survey over minimum and additional functions of the central office in various organisational group structures, see Bleicher (1979), *supra* note 163, p. 328ff.

the same purposes. Other central departments which only exist for advisory purposes and enable the central office to assist the subsidiaries -if necessary- are often also set up; these do not, however, reduce the responsibilities of the subsidiaries' management.²¹¹

Besides such advisory departments, (operative) functions can be coordinated or even centralized at the level of the parent or can be attributed to a specific subsidiary in order to exploit economies of scale and scope. Most common is a centralization of functions for purchasing, production, marketing (especially advertising), and distribution. Depending on the type of group often a dominant position of these fields may result.²¹² However, it may be contradictory to the standing of a subsidiary as a profit centre if, due to the centralization of functions, its management can no longer influence all the factors which are decisive for its profits. Moreover, it may be problematic to fix the internal prices for the transfer of these goods within the group. Therefore, attention has to be paid to the tradeoff between the economies achieved by such centralisation or coordination of functions and the disadvantages which can result for the organisational structure.²¹³

Furthermore, the central office often provides services for the member companies, such as central computer facilities, legal and insurance departments, or public relations. Such central services may lead to economies, as the subsidiaries do not have to build up their own facilities. On the other hand, the determination of transfer prices for these services are difficult, as often market prices for such specialized services do not exist.²¹⁴

Due to the contradiction in the profit centre standing, some groups consciously

²¹¹ See the central departments of *Siemens AG* and *BBC AG* (Germany), apud Schweitzer (1992), supra note 120, columns 2082f.

²¹² Scheffler (1985), supra note 10, p. 2009; called "operative synergies" by Bühner (1991), supra note 127, p. 128. As an example see the takeover of the department store chain *Hertie GmbH* by its competitor *Karstadt AG*, this was explicitly justified with advantages of common purchasing and common logistics, *FAZ* from 6 November 1993, p. 14 and interview with the *Karstadt AG* director Deuss, *FAZ* from 13 November 1993, p. 15.

²¹³ Bleicher (1991), supra note 124, p. 655f.; Scheffler (1987), supra note 184, p. 482.

²¹⁴ cf. Bühner (1991), supra note 127, p. 128.

renounce the possible advantages of coordinating operative activities or rendering centralized services. Especially if the parent is a mere holding company, the subsidiaries have to coordinate the necessary fields by themselves and the central management is limited to promoting a close cooperation in the group by producing transparency and confidence among the group members, its management, and its personnel.²¹⁵ Another possibility for exploiting economies by coordinating operative activities or offering services without putting them on the level of the central office is the transfer of certain functions to a specially set up group member; examples can be seen in subsidiaries for common purchasing or for providing computer facilities.²¹⁶

3. Advantages of the Group as Organisational Form - Unity and Variety in Economic and Legal Respects

The group as an organisational form stands between the market and the uniform company; in reality these are also the competing organisational forms for the group. The advantages of internal organisation in comparison with the market are shown above; what remains is to show the advantages of the group structure in comparison with the uniform company. The peculiarity of the group in comparison to the uniform company lies in the group's consisting of parts which are legally independent companies, the similarity of group and uniform company lies in their both substituting a market relationship by internal (hierarchical) organisation - at least to a certain extent.

In order to see the advantages of an organisation formed as a group an analysis should be made which effects the legal independence of the parts of the group have in an economic respect. Advantageous aspects of the group organisation cannot be seen by only examining the possibilities which the law allows for (economic) organisational structures and the restrictions which the law poses for them; thus the main question in this respect is not whether a decentralised organisation is also compatible with a

²¹⁵ Everling (1981), *supra* note 168, p. 2554; Bühner (1992), *supra* note 111, column 2276.

²¹⁶ Bleicher (1991), *supra* note 124, p. 653; Pausenberger (1975), *supra* note 151, columns 2242f.

uniform company²¹⁷ or whether only the group structure allows this kind of economic organisation.²¹⁸ Instead of simply analysing whether a specific organisation is compatible with a particular legal structure the way in which the legal independence of the parts can play an active role in the (economic) organisation of the group and to what extent the legal structure supports the goals of economic organisation of the enterprise must be examined. The question is whether the legal structure triggers organisational consequences which are advantageous in an economic sense. The advantages are connected with the topic of centralisation and decentralisation, however, not in the (narrow) sense that company law allows for a decentralised organisation only in the case of groups and sets restrictions to the same organisation for a uniform enterprise. It is rather to ask whether the group structure -with its various legal implications- may be especially suitable for helping to achieve the economic goals of a decentralised structure, although a decentralised organisation is compatible with both forms.

The organisational advantage of the group lies in the fact that the decentralised structure is also legally executed and therefore the economic structure is legally stabilised. Closely connected with these properties of the group form is the changed relationship of market and organisation in a group in comparison to a uniform company.

²¹⁷ According to the very predominant position divisionalisation is permitted in a uniform enterprise in the form of an AG, see Schmidt, "Abhängigkeit, faktischer Konzern, Nichtaktienkonzern und Divisionalisierung im Bericht der Unternehmensrechtskommission" *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 10 (1981), p. 479-486; for the opinion that there are no problems at all see Unternehmensrechtskommission, *Bericht über die Verhandlungen der Unternehmensrechtskommission* (1980), in Bundesministerium der Justiz (ed.), note 1735ff.; focusing more on the problems see Schwark (1978), supra note 166, p. 203ff.

²¹⁸ The effects of legal norms on organisational structures have been paid only a little attention in the economic literature, mostly interdependencies between legal form and organisational structure are neglected or even denied, see for a survey Debus (1990), supra note 159, p. 166f. An approach to examine the norms of the German public limited company (AG) and those of the AG as a subsidiary in a group with respect to whether they restrict or support a decentralised (or centralised) structure can be found by v. Werder, *Organisationsstruktur und Rechtsnorm* (1986), p. 52-54, 181-246, 438; id. (1989), supra note 177, p. 413-424. Unfortunately, he only analyses the highest possible degree of centralisation and decentralisation of a uniform company in comparison to different forms of groups according to the respectively relevant provisions of company law (ibid. (1986), p. 244 note 3) and only comes to the (right) result that a high degree of decentralisation is allowed in a uniform company as well as in a group. He sometimes touches the real problem, i.e., in which way legal norms can support the (economic) organisational structure to achieve the goals intended by it, but leaves it aside as an "empirical question" which is not determined by legal norms, see v. Werder, ibid. (1986), p. 53, 244-246, 442f; id., ibid., (1989), p. 424. A more fruitful approach is pursued by Debus, ibid., p. 167f.

Beside these organisational advantages of the group form for a decentralised economic structure, advantages derive from the possibility of dividing the ownership of a legally independent subsidiary and transferring it easily, as well as those resulting directly from the legal personality of the company.

a. Advantages of the Group Structure for Internal Organisation

By transforming profit centre units into legally formed bodies -therefore by transforming a uniform enterprise with a divisionsal organisation into a group- the goals of the above described decentralised organisation can be achieved, the semi-autonomous standing of the profit centres can be stabilised, and the economic structure can be made more transparent. The structure of the enterprise is made transparent outwards as the units represent legally formed bodies with legally defined business names.²¹⁹ The borders of the profit centres are also the borders of legally defined bodies.²²⁰ The profit centre standing is served by the legal construction of the company as an accounting unit, and this increases the outwards transparency of the profit centre as the balance sheet has to be published. Moreover, by choosing the suitable company form and shaping its memorandum and articles, the subsidiary can be designed precisely for its specific purpose.²²¹

A main point in stabilising profit centres by transforming them into legal bodies is the attribution of competences to different company organs by company law. Company law requires the establishing of different organs for a member company of a group. These organs have legally defined competences, the competences are divided among them and the competences of each organ are adapted to those of the others. Management and control in particular can already be divided by legal means between organs or the different members of one organ. The competences are defined in such a

²¹⁹ For the legal provisions for the choice of business names in Germany see *HGB* §§ 17-37.

²²⁰ cf. for a transparent organisation produced by the group organisation and the possibility of using the group structure for the contrary Hommelhoff, "Gesellschaftsformen als Organisationselemente im Konzernaufbau", in Mestmäcker/Behrens (eds.), *Das Gesellschaftsrecht der Konzerne im internationalen Vergleich* (1991), p. 109-112.

²²¹ Keller (1991), *supra* note 168, p. 1634f.

way that in the company a complex and interrelated system of decision-making is established and the institutions which exercise the competences build a complex system of checks and balances as a whole. This balanced system can be used to stabilise the economically desired autonomy of a profit centre, and makes it possible for the subsidiary to form a centre of its own economic activity, different from the one on the top of the group, although coordinated by it. Moreover, for the members of the organs, statutory liability is established with regard to the correct use of these competences which may also help to stabilise the use and division of competences. The design of the organs and their competences differ according to the company laws of the different countries and different legal forms, and thus the efficacy of such a stabilisation of the company by a legal organisational order may vary.²²² Nevertheless, an assignment of different tasks in the company to different organs exists for all companies with their own legal personality and limited liability; therefore the given legal organisation of the company is always designed for such stabilisation to some extent.

el IV This does not mean that the above-stated conflict²²³ between the organisational order of company law and that of the group is solved. The influencing of the company from the outside -by the general group management- still goes against the intended organisational order by company law; however, since the tendency of legally formed bodies to gain a greater independence from the general management of the enterprise/of the group can be used for the purposes of economic organisation, the influencing of the company by the general management has to be made compatible with the existence of different organs with legally defined competences. In this case the conflict between the group structure and the legal construction of the company as an independent entity is mitigated. Moreover, this does not mean, either, that in actual groups the concept is used in this way and that the subsidiaries are given a this kind of autonomy; groups, in reality, may also be directed in a very centralized way without making allowances for the system of checks and balances and other requirements of the legal person. However, the legally designated division of competences between organs *can* be used to stabilise

²²² For a description of the checks and balances in the organisational order of the *AG* and *GmbH* as affiliated companies, see Hommelhoff (1982), *supra* note 15, p. 224-232.

²²³ See above A and below C IV.

economic units and the law *can* be taken seriously in groups as it fulfils an economically desired function.

The (semi-) autonomous nature of the unit may also be stabilised by attributing a legal company interest to the company. A purpose or interest of the company is already defined for the company's original incorporation; this might serve as a guideline for the decisions of the company, although it is normally very general. Also, afterwards, company law ascribes an interest to a company, also for companies which are members of a group.²²⁴ As a matter of fact, the interest of a completely independent and autonomous company may be different from that of a group member, as the latter company may be guided not only by its own interest but also by the interests of the group. Thus conflicts between the interest of the single company and the interest of the group may arise; but normally the interest of the company and that of the group harmonize with each other as the group is also interested in the well-being of the company. Furthermore, it may be in the interest of the company to pursue the interest of the group as the cooperation with other group members may endow the company with a wide range of new and profitable activities and other advantages of close cooperation. Thus in a group, company interest and group interest are normally mixed and the interest of the single company cannot easily be isolated from the interest of the group - at the most in cases where the company is seriously damaged for the advantage of other companies in the group.²²⁵

Nevertheless, by also taking into account the group interest a certain self-interest on the part of the legally determined company remains, particularly as there are legally formed organs of the company (see above) to develop and to pursue this interest. The group therefore cannot be seen as pursuing only one interest, fixed at the top of the group, since normally the subsidiaries and profit centres pursue their own success and

²²⁴ See for the different approaches to define the company interest (of an independent company) Teubner, "Company Interest: The Public Interest of the Enterprise 'In Itself'", in Rogowski/Wilthagen (eds.), *Reflexive Labour Law* (1995).

²²⁵ cf. for the difficulty of separating the company interest from the group interest and the normal occurrence of the company interest fusing with the group interest Druey (1980), *supra* note 14, p. 305-308.

as well as the success of the group.²²⁶ Such self-interest serves a profit centre as a guideline for pursuing the goal for which it was established: to make profits in the market. Thus, the relativised legal self-interest of the company in the framework of the group interest may also stabilise the unit in the economic structure and increase the economically desired independence of the unit; thus this self-interest may be used to guide the activity of the company for its own benefit and the benefit of the whole group. Such legally intensified self-interest of a small(er) unit may also strengthen the motivation and identification of managers and employees with the subsidiary: their relation to a smaller unit with a prominent interest is probably stronger than it would be to the large organisation of a uniform company.²²⁷

The legal stabilisation of the economic unit has to be connected with the use of the principles of market and organisation in the group. Profit centres are strictly aligned to the market; this orientation of a part of the enterprise towards the market can only be carried out completely if the separate standing of the enterprise is also valid to the outside. This is only possible if part of the enterprise is formed as a company with its own legal personality in whose name contracts can be concluded and to which -to put it in general terms- rights and duties can be attributed.²²⁸ The group structure makes a comprehensive decentralisation outwards also possible, the subsidiaries act in the market in their own names and the consequences of the activity are directly attributed to them as legal persons. This facilitates the function of a profit centre, the consequences of its activities need not be ascribed to the subsidiary only by internal accounting, as it would be necessary if the profit centre had no legal personality. The legal self-interest of the company also serves as a guideline for its activity in the market, and it is not necessary to create an interest by organisational means.

A further aspect is the mix of market and organisational elements in the group.

²²⁶ For those interests in the group see Teubner (1991), *supra* note 40, p. 200; Wiedemann (1980), *supra* note 13, p. 348; Schneider (1991), *supra* note 25, p. 574.

²²⁷ For motivational effects see Bleicher (1992), *supra* note 158, column 1163.

²²⁸ Forms of partnerships without a legal personality are not necessarily excluded, see for Germany the *oHG* and the *KG*, *HGB* §§ 105ff., 161ff., especially § 124; but they are not dealt with in this study.

The separation of market and organisation is no longer as clear in the group as in the uniform company without a divisional structure: in the latter form a hierarchical organisation prevails in the company whereas the external relations are governed by the market. In the group, the member companies are not completely subordinated to a hierarchical structure but always have some properties of independent companies; the group as a whole is defined by hierarchical elements as well as by market elements.²²⁹ The member companies themselves are exposed to the external market, not only as parts of the whole enterprise. Therefore, market control can partly be substituted for directly hierarchical control. If the company is not completely owned by the parent and is quoted at the stock exchange, the control of the company might even be partly taken over by the capital market.²³⁰ Also within the group there is not only a hierarchical relationship between the group members, but also market elements, as there are internal markets for goods, projects, capital, personnel, and managers.²³¹ The mix of market and organisational elements within the group is not fixed, but flexible according to actual needs: the group can choose ad hoc and opportunistically the suitable blend between market and organisation, as well as the necessary degree of centralization.²³² Such an organisation is only feasible if the units are formed with legal personality so that they can act in the market as separate entities.

b. Other Advantages

Other advantages of the legal independence of subsidiaries can be seen in the possibility of dividing the ownership of the company and transferring it easily.²³³ The possibility of dividing the ownership of the company is important for joint ventures of different enterprises, since they often bring together their activities in a special field and form a joint undertaking which is more competitive - particularly important for

²²⁹ Ordeltjeide (1986), *supra* note 17, p. 296.

²³⁰ See Debus (1990), *supra* note 159, p. 169.

²³¹ In general for the implementation of market principles into organisation (and vice versa) see Imai/Itami (1984), *supra* note 85, p. 285ff.

²³² Kirchner (1985), *supra* note 43, p. 226; Teubner (1991), *supra* note 40, p. 198; Pausenberger (1975), *supra* note 151, column 2243.

²³³ See for the increased flexibility of the group structure in this respect with examples Bühner (1987), *supra* note 153, p. 45f.; Keller (1991), *supra* note 168, p. 1634f.

international markets.²³⁴ A subsidiary also makes the participation of other shareholders possible and thereby their status as residual claimants. Thus, local entrepreneurs in particular can be given an interest in distribution companies, in which the high incentive intensity of the market is decisive.²³⁵ In this way also managers and employees can hold shares of "their" company, and this can increase motivation and identification with the company. If instead, they held shares of a larger parent company, normally their efforts would have no effect on the value of the parent's stock.²³⁶ Such participation of outside capital in subsidiaries can also facilitate financing in a group. By including outside capital in a subsidiary, the entrepreneurial activity under unified management can be widened without the need for the parent to make the whole amount of capital necessary available. This can lead to exploitation of minority shareholders and to the complex constructions of groups with different levels like pyramids in order to reach a maximum of entrepreneurial control with a minimum of capital. However, this longstanding problem is today not found to any great extent in developed countries.²³⁷

The easy transfer of the ownership of companies makes it possible to change the composition of the subsidiaries according to the situation in the market and the current strategy of the group.²³⁸ This can be used for a diversification of the enterprise in order to balance the risk of different lines of business in the sense of portfolio management;²³⁹ it is also useful to build up new fields of business in related areas and to acquire suitable firms for this so that the advantages of close cooperation can be exploited. Through this possibility of changing the composition of the subsidiaries the group as a whole gains flexibility as it can easily adapt its strategy to changes in the environment which are so grave that it would not be enough if only the single

²³⁴ See, e.g., the splitting up of the steel division of *Krupp AG* in 5 legally independent companies in order to form joint companies in several fields with different partners, *FAZ* from 18 June 1994, p. 15.

²³⁵ See examples apud Kallfass (1991), *supra* note 16, p. 29f.

²³⁶ See the example of *Rohm* apud Milgram/Roberts (1992), *supra* note 35, p. 572f.; other example for the shareholding of the subsidiary's management apud Keller (1991), *supra* note 168, p. 1636.

²³⁷ Kallfass (1991), *supra* note 16, p. 38f.; Pausenberger (1975), *supra* note 151, column 2236f.

²³⁸ See for the actual need of the enterprises to adapt to changes in the environment by transforming the composition of the subsidiaries Bühner (1987), *supra* note 153, p. 45; Bleicher (1992), *supra* note 158, column 1154.

²³⁹ See for portfolio planning Eccles/White (1986), *supra* note 142, p. 206-213.

subsidiaries reacted to it. The spinning-off of divisions is much more difficult if the divisions are not formed as subsidiaries, and often the transformation of divisions into subsidiaries is the first step in order to sell them.²⁴⁰

Besides such advantages there are other advantages which come directly from the legal form, such as a subsidiary having its own business name. The limited liability of a company could also belong to these advantages, but this feature of the legal form of a company may also have organisational effects²⁴¹ and could affect directly the position of the creditors. Just how far a limited liability may be justified in groups will be dealt with below.

c. Conclusion of the Advantages of the Group as an Organisational Structure

The different properties of the legal person provide for a structure which enables the division of an enterprise to form its own centre of economic activity, different from that on the top of the group. Particularly important properties in this respect are that the subsidiary is a point of legal attribution of rights and duties and that an interest which is to be pursued by special company organs is legally ascribed to the company. A decentralised group organisation with a semi-autonomous profit centre standing of the units and an introduction of market elements into the organisation aims at exploiting these qualities for its own economic purposes. In this organisational structure the company forms a quasi natural body for a strict alignment of a profit centre to the market - even if it is somehow dependent on the top of the group. In such a group in which the economic organisation uses the elements of the legal structure, the term of the unity and variety of the group no longer only expresses the contrast between the variety of legal persons and the unity of the group as a single economic actor, since the

²⁴⁰ See the spin-off of divisions of the *AEG AG* in order to sell them to other enterprises as they no longer fitted the strategy of the parent *Daimler-Benz AG*, which wanted to concentrate on technology for different means of transport, *FAZ*, 4 December 1993, p. 14.

²⁴¹ cf. Debus (1990), *supra* note 159, p. 169f., 172; cf., on the other hand, the examples of *Daimler-Benz AG*, *apud* Theisen (1991), *supra* note 17, p. 55, and of *MAN AG*, *apud* Bühner (1987), *supra* note 153, p. 41f.; both groups are formed as "management holdings" in order to exploit the organisational advantages of the group, but they are formed by the use of control contracts so that the parent company is liable for the debts of the subsidiary (*AktG* § 308); thus the organisational advantages of the group do not necessarily seem to depend on the separation of liability.

term shows the points in between which the group can oscillate: in the group there are a variety of centres of economic activities which can be held together with a certain degree of unity by the top of the group.²⁴² Without the legal personality of the group members, in the form of a uniform company, the units could not free themselves from the centre in this way and perform this function.

The group structure increases the flexibility²⁴³ of the enterprise on three different levels. First, the subsidiary as a profit centre which is much smaller than the enterprise gains flexibility as it is closer to the market and can react faster to changes in the environment. The legal structure of each subsidiary can be designed with regard to its specific purpose. Second, the structure of the group is more flexible as it is not only fixed to organisational direction, but internalizes market elements. Third, the group as a whole gains flexibility as it can change the composition of subsidiaries and can therefore change the fields of business according to strategic needs and can make joint ventures in specific fields with suitable partners. In such a flexible concept for enterprise organisation by a group form, the single units must be given some autonomy and must have a somehow independent standing from the centre as otherwise the units would not be separable from the group and the flexibility of the whole group could not be achieved. This also tends towards a greater market orientation of the subsidiaries and to a less frequent use of hierarchical means.

IV. Conclusions to the Economic Section

The legal structure of the group of companies is suitable for the economic organisation of an M-form enterprise. The subsidiaries, as legally independent companies, take the place of divisions and have a profit centre standing; they are given a wide degree of autonomy. The general management in the M-form is replaced by a group management,

²⁴² Teubner (1991), supra note 40, p. 198-200; Hommelhoff (1982), supra note 15, p. 227-233; Pausenberger (1975), supra note 151, column 2235, 2243.

²⁴³ See for flexibility as need of enterprises at the time being and the relevance of flexibility in the different fields of the enterprise activity Meffert, "Größere Flexibilität als Unternehmenskonzept", *Zeitschrift für betriebswirtschaftliche Forschung* 37 (1985), p. 121ff.; for an analysis of the organisational flexibility of different legal forms as subsidiaries see Hommelhoff (1991), supra note 220, p. 119ff.

normally that of the parent company. Through this type of management, which manages all the members of the group on a unified basis, the group may act as a uniform economic actor and can exploit the advantages of internal organisation/firm coordination over market coordination, thus furthering cooperation and the pooling of resources in order to exploit economies of scale and scope, economies on transaction costs, and the advantages which the organisation offers as a holder of knowledge.

In order to achieve the advantages of internal organisation in the organisational form of an M-form enterprise, those of combining high integration with a far-reaching decentralisation, group managements have to coordinate their subsidiaries and to limit their autonomy to a certain extent. The responsibilities are in principle divided along a line running between strategic and operative management; thus group managements are responsible for the strategic questions of the whole group and the subsidiaries, while the managements of the subsidiaries are responsible for the operative side, particularly for everything that is closely related to the specific markets of the subsidiaries. The other area assigned to group management is that of financial management, which is closely connected to the strategic field and forms a basis for both planning and the control mechanisms in the M-form. In contrast to the above, the financial area is often more centralized. The instruments used to direct the management of the subsidiaries are seldom the classical hierarchical ones such as instructions, but include more indirect measures such as budgets, programmes, committees and meetings, a comprehensive accounting and auditing procedure as a basis for planning and control, and the appointment of the management of the subsidiary. Informal devices such as committees, programmes, and meetings are used to transfer information between the subsidiary and the parent (and vice versa) and among the subsidiaries themselves, as well as to further close cooperation between the subsidiaries. Control is also not directly exercised by monitoring the whole activity of the subsidiary, but mainly by controlling its profits. In addition, other fields of management are sometimes coordinated or centralised if advantages can be achieved by this, especially economies of scale and scope. For the continuous coordination of the subsidiaries, e.g. with regard to transfer prices, they are themselves mostly responsible, without any interference from the central management. Hierarchical instruments are also replaced by market mechanisms, internal markets

allocate resources to the best internal use, and the subsidiaries are exposed to external markets which partly take over the direction and control of them.

The interventions of the central management find a limit in the logic of the profit centre concept. The tasks attributed to the subsidiaries, the competences of their management, and the responsibility of the management for the subsidiary's profit must coincide. If the interventions of central management exceed this limit and a wide degree of autonomy for the subsidiary and its management is not maintained the profit centre structure will not work. Instead of giving rise to a clear and transparent structure, an opaque, decentralised organisation emerges in which competences and responsibilities are not clearly attributed, success or failure cannot be assigned to those responsible, and control of the subsidiary through arbitrarily determined profits (or losses) is not possible.

In order to remain in the logic of the concept, on the other hand, the profit centre must be aligned to the market; as a profit centre the subsidiary has to develop a self-interest to prove itself in the market by being successful and making profits there. Thereby while the (management of the) profit centre pursues its own interests, it pursues at the same time the interest of the group to maximize overall profits, and it pursues its entrepreneurial interest within the framework of that of the group. Thus, the position of the subsidiary in the group is not only determined by a hierarchical relationship in relation to the central group management, but also to a great extent by a market relationship: it is exposed as a separate unit to the external market, and within the organisation also market elements are integrated so that internal markets arise.

The economic logic therefore provides for a high degree of autonomy for the subsidiaries, and the legal company form of each subsidiary stabilises the autonomy and the independence of each economic unit and profit centre. Thus, the economic organisation may reap the benefits from the legal structure of the company.

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C. Efficient Law for the Group

I. The *GmbH* as an Affiliated Company in the Group

The objectives of company law when dealing with groups were defined above in order to establish an efficient legal framework for the group. Two aspects of efficiency have to be taken into consideration, on the one hand the efficient working of the group as an organisation, and on the other, an efficient relationship between the group or its member companies with the external parties which have a stake in the member companies. In the latter case, the standing of the creditors of the affiliated company will be analysed. The goal is therefore to establish a legal framework which makes the exploitation of economies by the organisational form of the group possible, without shifting burdens to other parties and externalising costs in so doing.²⁴⁴ In legal terms, the goal is to establish legal provisions which will form an adequate organisational structure for the group and which, on the other hand, will protect the interests of external parties, here the creditors. The law for groups therefore has to be organisational as well as protective. These two aspects of the law for groups do not necessarily have to be pursued separately, since the fixing of a certain structure by company law may also act as a safeguard for interests which require such protective measures; therefore organisational law and protective law may coincide.²⁴⁵ The criterion for evaluating the law in both respects remains that of efficiency.

The main topic of the analysis is the law of the German *GmbH* as an affiliated company. It will be assessed whether the law allows an efficient organisational structure for a group with an affiliated *GmbH* to form. The efficiency of the group as an

²⁴⁴ cf. for efficiency in both respects as goals of a law for groups Kallfass (1991), *supra* note 16, p. 48; Assmann, "Der faktische GmbH-Konzern", in Lutter et al. (eds.), *Festschrift 100 Jahre GmbH-Gesetz* (1992), p. 734; Kirchner, "Ansätze zu einer ökonomischen Analyse des Konzernrechts", *Jahrbuch für Neue Politische Ökonomie* 3 (1984), p. 250.

²⁴⁵ In general for the two objectives of the law for groups, i.e. organisational and protective law, see Schmidt, *Gesellschaftsrecht* (1991), 2nd ed., p. 400-404; Druey (1980), *supra* note 14, p. 289; Lutter, "Zur Aufgabe eines Konzernrechts: Schutz vor Mißbrauch oder Organisationsrecht?", in Druey (ed.), *Das St. Galler Konzernrechtsgespräch* (1988), p. 228-232; for the concrete relationship between organisational law and the protection of the creditors of the affiliated company, Hommelhoff, "Konzernpraxis nach 'Video'", *Der Betrieb* 45 (1992), p. 314.

organisational form depends above all on the possibility of performing unified management, thereby influencing the management of the subsidiary by hierarchical means to a certain extent. The above described structure will be taken as the model for the efficient organisation of an enterprise with a minimum of hierarchical elements. The organisational concept will be compared to the legal concept of the *GmbH*, and of particular interest will be the question whether the extent to which the organisation uses hierarchical elements in its dealing with the affiliated company, and the means used in order to establish the hierarchical relationship are compatible with the legal concept.

This organisational structure is also taken as a basis in order to analyse the position of the creditors of the affiliated company. The crucial point with regard to the creditors is the limited liability of the single member companies of the group and therefore the separation of liability between the group members. There are two main questions when examining this field. One question is how the positions of the creditors are transformed if their company is a member of a group which is organised in the organisational form as described above; hence, it is to evaluate whether the legal instruments for the protection of the creditors in a company with limited liability are still sufficient in a group that is organised in this way. In the analysis organisational law will be also included, the organisational law may be protective (towards the creditors) at the same time. The more general question is whether the limited liability of companies in a group organised according to the above described concept can still be justified, or whether even in such a decentralised organised group there are no more viable economic reasons for granting limited liability to each company in the group.

In Germany there is no statutory legal regime for groups with a *GmbH* as an affiliated company; this kind of special regime exists only in regard to public limited companies, *AGs* (*AktG* §§ 291ff.). The law for groups with a *GmbH* as subsidiary is divided into two main sections. On the one hand, there are groups which are formed according to contracts; their legal treatment is based on an analogy to the provisions for the *AG*. On the other hand, there are de facto groups for which judge-made law has been developed. The legal consequences differ significantly between these two types of groups, especially in the two areas here relevant. In a first step, the group formed

according to a contract will be examined, while in a second step the de facto group will be examined with regard to both questions.



II. The *GmbH* in a Group based on a Contract

The parent can base the subsidiary relationship with a *GmbH* on a control contract, which is drawn up as an enterprise contract between the two companies. The control contract is often combined with an agreement to transfer profits.²⁴⁶ If a control contract is concluded between the parent undertaking and subsidiary company, they form associated undertakings and it is assumed that they form a group (*Konzern*) under a unified management.²⁴⁷ There is agreement that for a *GmbH* whose affiliation is based on a control contract the appropriate statutory provisions for the *AG* must be applied by analogy.²⁴⁸

The agreement on a control contract interferes strongly with the structure of the subsidiary company²⁴⁹ and is dependent on certain conditions, particularly on the consent of the shareholders of both the companies involved.²⁵⁰ Two legal consequences of the fixing of a control contract are relevant in this context.

The first consequence is the legalization of performing unified management over the companies in a group (*AktG* § 308 (1)). The directors of the affiliated company are obliged to comply with the instructions which the directors of the dominant enterprise issue to them; nevertheless, the organisational structure of the subsidiary is not

²⁴⁶ There are other types of enterprise contracts (*AktG* § 292) and the "Eingliederung" (*AktG* § 319ff.) as a further form of parent subsidiary relationship which is even more far-reaching than the agreement on a control contract; however, only the group based on a control contract is exemplified as the main alternative to a de facto group.

²⁴⁷ *AktG* §§ 15, 18 (1) 2nd sentence.

²⁴⁸ The relevant provisions are *AktG* §§ 291-310; see BGHZ 105, 324 - Supermarkt; BGH NJW 1992, 1452 - Siemens; Emmerich/Sonnenschein (1993), supra note 186, p. 468.

²⁴⁹ With the control contract, the organisational structure and objectives of the company are altered, see Zöllner, "Inhalt und Wirkungen von Beherrschungsverträgen bei der GmbH", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 21 (1992), p. 174, 177.

²⁵⁰ *AktG* §§ 291f.; see in detail with particularities for the *GmbH* BGHZ 105, 324 - Supermarkt; BGH *Neue Juristische Wochenschrift* 1992, 1452 - Siemens; Emmerich/Sonnenschein (1993), supra note 186, p. 471f.

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completely eliminated, its directors are still responsible for its management in general. The right to issue instructions holds in all areas relating to the conduct of the subsidiary's business. Instructions may be issued by the dominant enterprise, even if they are detrimental to the dependent company, as long as they serve the interests of the group; in this respect the subsidiary's directors can only refuse to carry out the instructions if they obviously do not serve the group interest. These instructions should not be contrary to the law, morals, provisions of the subsidiary's statute, or the control contract itself. Further limits have been developed in the academic debate; instructions may not lead to the insolvency of the affiliated company and the parent company may not withdraw the liquidity necessary for the survival of the subsidiary.²⁵¹

In comparing this very far-reaching authorization to determine the subsidiary's management with the above described structure of decentralised organisation, it has to be acknowledged that this structure does not rely only on instructions in order to influence the subsidiary's management but on other, more indirect, management devices. The implementation of the goals of strategic management in plans, budgets, and programmes, the continuous coordination of the subsidiaries, and the decision about the centralization or coordination of special fields which belong to the subsidiary's business may all be described as "instructions". All the informal measures to adapt the company activities and interests to the group activities and interests, such as joint committees and a comprehensive accounting and auditing procedure, there are some doubts as to whether they can be described as instructions. Nevertheless, in the organisational concept described these measures are very important in order to align the member companies to the goals of the group (or vice versa). Finally, instructions can be completely substituted by interlocking directorates. Hence, the question emerges whether the concept of the control contract is compatible with more indirect management devices such as those in a decentralised structure.

²⁵¹ See in detail with partly controversial opinions Koppensteiner, *Kölner Kommentar zum Aktiengesetz* (1987), 2nd ed., § 308, note 17-39; Geßler, in Geßler et al. (eds.), *Kommentar zum Aktiengesetz* (1973), § 308, note 31-59; Zöllner (1992), *supra* note 249, p. 186-192; for the survival of the company as a limit of the right to issue instructions OLG Köln, *Die Aktiengesellschaft* 1990, 490, 492.

The concept of a group based on a control contract makes the very close relationship of a group possible. The concept changes the structure of the company, since the company is no longer focused upon its own self-interest, and the group interest may become the permanent guideline for the activity of the company,²⁵² particularly where the group interest and company interest are no longer separable in the concrete activity of the subsidiary. Material limits regarding the domination of the subsidiary occur only as a result of the above described limits on the right to issue instructions, especially the self-interests of the subsidiary are limited to not being very seriously damaged and not being led into bankruptcy. Within these very wide limits, a very detailed determination of the subsidiary's business activities is also allowed.

As the informal measures do not really affect the self-interest of the subsidiary, there is agreement on the fact that they are permitted.²⁵³ Interlocking directorates are more problematic as the exercise of competences in the organs of different companies are no longer separated. Conflicts of interests may arise since the directors of the affiliated *GmbH* are obliged to verify if the instructions do not exceed their legal limits.²⁵⁴ However, in a group based on contract, the company interest of the subsidiary is replaced by the group interest²⁵⁵, and as this is also relevant for the management of the parent company, the director(s) are obliged to pursue the group interest in both companies. Only once these have gone beyond the limits of the right to issue instructions, may conflicts of interests appear.

In the organisational structure described, however, the actual purpose of interlocking directorates is to ensure that the subsidiary's interest are better taken into account by formulating group policies and enforcing them at the level of the subsidiary. Since this structure has been established to ensure that the best policies for the group and the subsidiary are pursued, conflicts of interests, at any rate those going beyond the

²⁵² Geßler, *ibid.*, note 74-76; Koppensteiner, *ibid.*, note 48f.

²⁵³ Emmerich/Sonnenschein (1993), *supra* note 186, p. 85, 349f.; for this result with respect to a comprehensive accounting and auditing procedure see Scheffler (1991), *supra* note 195, p. 260f.

²⁵⁴ See *AktG* § 310; Geßler (1973), *supra* note 251, note 66; Koppensteiner (1973), *supra* note 251, note 45.

²⁵⁵ See Hoffmann-Becking, "Vorstands-Doppelmandate im Konzern", *Zeitschrift für Handelsrecht* 150 (1986), p. 575, 582.

wide limits of the right to issue instructions, should rarely occur in this structure. If they do, the director must avoid infringements of the duties towards the respective company, particularly towards the affiliated company.²⁵⁶ Thus, the predominant view is that interlocking directorates are permissible in a group based on a control contract.²⁵⁷

Therefore, the term "instruction" is interpreted in such a way as to include all the instruments by which the parent influences the subsidiary and creates a unified management over the companies. Thus, all instruments are in general allowed in a group based on a control contract, but, on the other hand, they should not exceed the limits which are outlined for "instructions".²⁵⁸

On the other hand, German company law has taken steps to protect the assets of the dependent company in the interest of the creditors. It has not imposed any direct liability on the parent company for claims against the dependent company but it has established the statutory obligation for the dominant company to balance the dependent company's annual deficit (*AktG* § 302). The deficit may be made good out of free reserves only in so far as the latter were created during the existence of the control contract. The right to compensation arises as soon as the balance sheet is drawn up. The creditors of the dependent company can require the company to charge and assign its claim to compensation. In this way an indirect liability is imposed on the dominant company. This method of safeguarding the assets is supplemented by certain obligations to create the statutory reserves in the dependent company (*AktG* § 300), by laying down precise rules on the possibilities to transfer profits, and by additional safeguards for the creditors of the affiliated company if the contract is terminated (*AktG* § 303). A direct liability on the part of the parent is not established with this system; nevertheless, the

²⁵⁶ See OLG Köln *ZIP* 1993, 110, 114; Emmerich/Sonnenschein (1993), *supra* note 186, p. 359.

²⁵⁷ Affirmative for the permissibility of interlocking directorates (at least) in contract based groups (for de facto groups below) OLG Köln *ZIP* 1993, 110, 114 with in this respect affirmative comment by Timm, *ibid.*, p. 117; Emmerich/Sonnenschein (1993), *supra* note 186, p. 349f., 358f.; Hommelhoff, "Konzernmodelle und ihre Realisierung im Recht", in Druey (ed.), *Das St. Galler Konzernrechtsgespräch* (1988), p. 124f.; Hoffmann-Becking (1986), *supra* note 255, p. 582; Strey, *Zur konzernrechtlichen Problematik von Vorstandsdoublemandaten* (1992), p. 171f.

²⁵⁸ See Emmerich/Sonnenschein (1993), *ibid.*

creditors seem to be rather well-protected against the additional dangers which appear for them in a group.²⁵⁹

At first glance, the law for an affiliated *GmbH* in a group which is based on a control contract seems to fit rather well the above-stated criteria for evaluating a law of groups, giving enough leeway for an efficient organisation of the group and an efficient protection of the creditors. However, the legal structure of the group based on a control contract is rather closer to that of a uniform enterprise, and realizes to a lesser extent the specific pattern of a decentralized group organisation. The legal structure changes the model of the group, giving less variety and more unity.

This can be seen especially in the right to issue instructions to the directors of the subsidiary. In the above-described decentralised organisational structure, the business activity of the subsidiary is directed more by indirect measures, whereas the direction of the subsidiary through instructions, which are in addition legally binding and can be enforced in court according to the concept of a control contract, is based on the image of a strictly hierarchical organisation between parent and subsidiary. The subsidiary is seen less as a real centre of economic activity; while the parent can entirely determine its business activity by instructions, the limits of this right are not very relevant for normal business activity.

The same can be pointed out with regard to the provisions of the parent's liability, i.e. the installing of an obligation on the parent to balance the annual debts of the subsidiary. Even if no direct liability of the parent for the subsidiary is assumed, in effect the parent is held responsible for the losses of the subsidiary, thus the separation of liability in a group is almost completely eliminated. As a result, the parent has to bear the consequences of the subsidiary's economic failure and the parent's directors are held directly responsible for this by their shareholders. The elimination of the subsidiary's limited liability may have direct organisational consequences in that the

²⁵⁹ See for the system and detailed criticism Koppensteiner, *Kölner Kommentar zum Aktiengesetz* (1987), 2nd ed., preliminary note, § 300, note 3ff.; Emmerich/Sonnenschein (1993), *supra* note 186, p. 286-305.

parent will increase its control over the subsidiary and the subsidiary will be granted less autonomy - in other words, the group will not be organised in such a decentralised form.²⁶⁰ The elimination of the liability separation between the companies also illustrates that the statutory model is a group in which room for the autonomous responsibility of any economic risks on the part of the subsidiary does not exist; instead the parent is obliged to shoulder the economic risks as it is viewed as having full control over the subsidiary. This leads to a further consideration of the notion of efficiency in this field: whether it is necessary to abolish the limited liability of affiliated companies in order to establish an efficient relation with the creditors, or whether limited liability can also be justified for reasons of efficiency as a basis for the separation of liability between companies in a group. Accordingly, the extension of liability on the parent for the protection of creditors may abolish the efficiency effects of limited liability. This problem will be dealt with further on.

The predominant legal feature of the group based on a control contract is therefore not that of a decentralised organisation with several centres of economic activity, as it is described above, but rather the centrally directed group with only one centre of economic activity at the top. The model which legally corresponds to a decentralised structure is therefore seen in the *de facto* group in the economic literature.²⁶¹ This does not mean, however, that a group form based on a control contract cannot be chosen for such an organisational structure of this type. The form of a contract based group (with an agreement to transfer profits) used for a decentralised structure may be chosen for tax reasons in particular as in this case profits and losses between different companies in a group can be set off.²⁶² Nevertheless, it is important to note that a very close group organisation is possible within German company law since groups which want to rely on directly hierarchical means more heavily than used in a decentralised organisation do not have to act unlawfully or transform themselves into a uniform company. They can choose the contract based group as the legal form

²⁶⁰ Debus (1990), *supra* note 159, p. 168-171.

²⁶¹ See Bleicher (1992), *supra* note 158, column 1163f.

²⁶² *Körperschaftsteuergesetz* §§ 14, 17; see Emmerich/Sonnenschein (1993), *supra* note 186, p. 189-197.

which fits their organisational needs and guarantees at the same time the standing of the creditors of the affiliated company.

III. The *GmbH* in a de facto Group

In order to analyse whether the law of de facto groups for a *GmbH* as an affiliated company complies with the above-stated criteria of efficiency in both respects, it is first necessary to look at the legal structure of the *GmbH*. The protection of the creditors will be analysed afterwards on the basis of the organisational legal structure of the *GmbH*.

1. Legal Structure of the *GmbH* with regard to its Standing in the Group as an Affiliated Company

The *GmbH* is a company with its own legal personality and limited liability. These two components of the *GmbH* give rise to several implications, and in order to analyse the legal structure of this company form it is first and foremost fruitful to look at the characteristics of the legal person in the concrete form of the *GmbH*.²⁶³

The *GmbH*, as a company and legal person, is an independent legal entity, distinct from its shareholders. Company law defines an organisational order for the company which is independent from its members and their composition. Events regarding its members do not generally affect the company, and one special characteristic is that the company can survive its members. The shareholders are not able to act directly for the *GmbH*; instead, the law (and the articles of the company in question) establishes an organisational structure for the company with organs which have abstractly defined competences. The organs take decisions for the company, manage it, and can also represent it; thus it can be concluded that the company is able to act by means of its organs. In the *GmbH* two organs are installed in principle, the

²⁶³ cf. with regard to the different approaches to defining the elements and/or the essence of the legal person Wiedemann (1980), supra note 13, p. 191-204; Flume, *Die Juristische Person* (1983), p. 1-31; interestingly, they differ in their approaches.

directors and the shareholder assembly. The principal competence of the directors is first and foremost to manage and represent the company,²⁶⁴ within the limits drawn by the law, the company's articles, and the instructions issued by the general assembly. The directors do not have to be shareholders but can be third persons. The shareholders exercise their rights in the *GmbH* especially in the shareholders assembly (*Gesellschafterversammlung*) -*GmbHG* § 48- which normally decides by a majority of the equity (*GmbHG* § 47). A main competence of the shareholders assembly is the right to issue instructions to the directors - within certain limits.²⁶⁵ Other organs can be facultatively installed, particularly a supervisory board²⁶⁶ or other controlling organs. Thus, the organisational order of the company is in principle detached and independent from its members, while the shareholders form a functional part of the organisation and only have participation rights in the organ(s).²⁶⁷

The company is subject of attribution of assets and equity capital. The company's assets are separated from the assets of its shareholders, and represent a separate fund which is attributed only to the legal personality of the company, only to be used for the fulfilment of the claims of its creditors. The independent patrimonial structure forms another element -besides the separate organisational structure- in order to establish the company's independence from its members and its being a separate legal entity. The separate fund of the *GmbH* is linked with the limited liability of the company, even if this is not necessarily construed as an obligatory element of the legal person.²⁶⁸

These elements -the separate organisation and assets of the company- are held

²⁶⁴ *Gesetz betreffend die Gesellschaften mit beschränkter Haftung, Gesetz vom 20. April 1892 (RGBl. S. 477), in der Fassung der Bekanntmachung vom 20. Mai 1898 (RGBl. S. 846), with all following amendments, hereinafter cited as GmbHG, §§ 35ff.*

²⁶⁵ See in detail Hüffer, in Hachenburg, *GmbH-Gesetz* (1990), 8th ed., § 45 note 15f., § 46 note 4.

²⁶⁶ *GmbHG* § 52; a supervisory board is mandatory if it is required by the codetermination laws.

²⁶⁷ See for a deeper-reaching focus on the organisation as the essence of the legal person and a view according to which the organisation as a collectivity is more detached from the shareholders, Teubner, "Enterprise Corporatism: New Industrial Policy and the 'Essence' of the Legal Person", 36 *American Journal of Comparative Law* (1988), p. 137ff.

²⁶⁸ See the French law according to which partnerships with unlimited liability of the members are also granted the status of a legal person and see Wiedemann (1980), *supra* note 13, p.220f.

together by the objectives of the company. The general objectives, which are laid down in the company's incorporation, include the subject matter of the enterprise's activity and, in the case of the company as a business organisation, the profit orientation of the company, as this normally forms the common purpose for the joining together of its members into a company.²⁶⁹ The guidelines for the concrete business activity of the company forms the company interest, what -very broadly speaking- aims at the realization of the company's objectives in a certain permanence. Given its special objectives and its own interest, the company forms an autonomous interest centre. The organisational structure of the company is established to pursue this interest, and the assets of the company have to be employed in the company interest. The organs of the company must therefore pursue the company interest. This is first and foremost true for the company's directors, as the organ which manages and represents the company (*GmbHG* § 35). They are obliged to carry out their activities according to the outlines laid down by the company interest and can be held liable for neglecting their duty.²⁷⁰

There is much controversy as to which institution is responsible for defining the company interest, and what the substantive content of the interest is; in particular, there is controversy over the identity of the groups whose interests have to be taken into account by defining the interest. One body of opinion holds that the company interest is determined only by the interests of the shareholders, thus the profit orientation of the company in the interest of the shareholders stands in the foreground of the company interest.²⁷¹ The second body of opinion sees instead the company itself as the institution which is the reference point of the company interest. This replacement of the shareholders interest by the self-interest of the enterprise causes essential shifts in meaning when the company interest is used as a guide for concretizing duties of care and the fiduciary duties of the company's organs. Even if the company interest is defined only by the profit orientation of the company, instead of focusing on the profit

²⁶⁹ Hueck, in Baumbach/Hueck, *GmbH-Gesetz* (1988), 15th ed., § 1 note 5; see for a detailed discussion including economic considerations and aspects of economic order, Wiedemann, "Grundfragen der Unternehmensverfassung", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 4 (1975), p. 413-417.

²⁷⁰ According to *GmbHG* § 43; cf. Schneider, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., § 43 note 59-63.

²⁷¹ See e.g. for a very straightforward statement of this opinion for the *GmbH* Schneider, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., § 43 note 62.

orientation in the interest of the shareholders, the standpoint is shifted to a more long-term perspective of making profits. This is because the company's organisational self-interest is directed towards its own self-preservation through making profits, whereas the interest of the shareholders is often directed more towards short-term profits - the interest in preservation of the company being achieved by continuous profitability which also (at least partly) covers the interests of other groups involved in the company.²⁷² Such a legal interpretation corresponds much more closely with the economic description of the specific goal of an enterprise, that is to say the achievement of long-term profits in order to preserve the enterprise as an organisation in the market.

Furthermore, other interests, besides the profit-orientation of the company, can be integrated into the company interest, which is no longer either directly or only determined by the interests of the shareholders, but also by the interests of the company's employees, by consumer interests, and by the interests of the general public (e.g. ecological interests). The company interest is then normally converted into the enterprise interest which may cover all the interests of the groups involved in the social association "enterprise".²⁷³ The interests of the employees -especially the preservation of the enterprise and their jobs- have to be taken into account in the enterprise interest according to the codetermination laws: in GmbHs which are subject to these laws owing to their size, a supervisory board has to be formed including representatives of the employees.²⁷⁴ In this approach, the company interest is only in second place defined

²⁷² Similarly Flume (1983), *supra* note 263, p. 58, who measures all interests in the company/enterprise involved on the given company interest which is directed towards the self-preservation of the enterprise by its profitability; unlike Wiedemann (1980), *supra* note 13, p. 626, who focuses on the determination of the company interest by the shareholders, as they secure the profit orientation of the company. However, it remains to ask why the shareholders are not more interested in short-term speculative profits instead of long-term profits which build a basis for the future existence of the enterprise.

²⁷³ See for the difference between company interest and enterprise interest with different remarks Westermann, "Rechte und Pflichten des mitbestimmten Aufsichtsrates und seiner Mitglieder", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 6 (1977), p. 222-224; Rehbinder, "Das Mitbestimmungsurteil des Bundesverfassungsgerichts aus unternehmensrechtlicher Sicht", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 8 (1979), p. 481-484; for the whole complex of "enterprise law" see Raiser, *Das Unternehmen als Organisation* (1969), *passim*, especially p. 111ff.; for different approaches to define the enterprise interest see Flume (1983), *supra* note 263, p. 57f.; for producing a link between the company as legal person and enterprise under keeping the categories of company law see Flume, *ibid.*, p. 48-50.

²⁷⁴ Ulmer, "Der Gläubigerschutz im faktischen GmbH-Konzern beim Fehlen von Minderheitsgesellschaftern", *Zeitschrift für Handelsrecht* 148 (1984), p. 396, 409f.

by substantive criteria; more importantly it results in the setting up of a procedure for integrating the different interests into the converged company interest, which remains the guide for the company's activity.²⁷⁵

The considerations regarding whose interests are to be included into the company interest and how it should be defined are not directly relevant for this study; the decisive question for us is rather whether company objectives and interest necessarily require that the company pursues its business activity independently or, to put it in another way, whether economic independence is a necessary constituent of the company form "GmbH". This question is related to the previous discussion because a company interest which could be determined by and was at the disposal of the shareholders would not set any fundamental constraints on a company's forming a member of a group - if all the shareholders were in agreement. On the other hand, the defining of an interest for an autonomous company could set limits to the membership of a company in a group.

The classical view is that company objectives and company interest aim at the independent activity of the company, this is also stated for the *GmbH*.²⁷⁶ Such an independent, autonomous activity presupposes an interest of the company itself, which forms the ultimate guideline for the company's activity. According to this view, the concretization of the interest only takes place within the company's organs free of "external" interests and the decision-making in the company must only take place in the interest of the company itself, without taking into account personal or -particularly- group interests. Such a view would object to the determination of the company's activity by any special interests of the shareholders - of the private (majority) shareholders, as well as of enterprises as parent companies. The company, according to this view, is conceived as a self-sustaining entity.

²⁷⁵ See Teubner (1995), supra note 224; Laske, "Unternehmensinteresse und Mitbestimmung", *Zeitschrift für Gesellschafts- und Unternehmensrecht* 8 (1979), p. 173ff., 196ff.; Brinkmann *Unternehmensinteresse und Unternehmensrechtsstruktur* (1983), passim.

²⁷⁶ Zöllner, in Baumbach/Hueck (1988), *GmbH-Gesetz*, 15th ed., annex II, note 8.

However, this view of independent economic activity as a necessary constituent of the company form cannot be sustained. This can be seen with regard to the concrete structure of the *GmbH*. The *GmbH* can be a one-man company²⁷⁷; a pluralism of interests on the part of the shareholders is difficult to imagine in this case. As the shareholder assembly -in the case of a one-man company, the only shareholder- can issue instructions to the directors for the company's management, the majority or even the only shareholder, where there is only one, can impose its view and interest on them. The directors are not given the legal means to withstand the legalized power of the shareholder(s). From this it is concluded realistically that the *GmbH* does not necessarily pursue an over-individual interest, but that it can be used to pursue very individual interests.²⁷⁸ The organisational structure of the *GmbH* cannot counterbalance the power of the shareholder(s), if the shareholders are not spread widely - as in the public company. This does not mean that a legally fixed organisational structure is unnecessary, only that the concrete organisational structure of the *GmbH* is not able to neutralizing the factual influence of the shareholders in the most common use of this company form.²⁷⁹

The limited force of the concept, which requires an independent economic activity for the company, can also be seen in the constraints to which the exercise of the shareholders' rights are subject. In an independent company, the shareholders are bound to the company interest (defined as the interest of an independent company) and exercise their rights by following objectives which are common to all shareholders. This concept is secured by the fiduciary duties of the shareholders towards the company and the other shareholders, and they are imposed on the shareholders to ensure that the company is directed only in its own (company) interest. Thus, the criterion for determining the substance of the shareholders' fiduciary duties is the company

²⁷⁷ See *GmbHG* § 1. The foundation of a private limited company as a one-man company is in all Member States of the European Community admissible, see 12th EC Directive on the harmonisation of company law, 89/667/EEC - OJ EC No L 395, 22.12.1989, p. 40. It had to be transformed into national law until the 1st January 1992, Art. 8 of the directive.

²⁷⁸ Westermann, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., introduction note 5.

²⁷⁹ Westermann, *ibid.*

interest.²⁸⁰ With regard to the formation and business activity of a group, the fiduciary duties of the majority shareholder function as a protection for the minority. During the formation of a group, the fiduciary duties require under certain conditions that the shareholder assembly agrees to the company becoming dependent on a group; the criterion for controlling the shareholder resolution is the company interest.²⁸¹ When doing business in the group, the parent is obliged by fiduciary duties not to influence the affiliated *GmbH* in such a way that it is damaged. If this should happen, the minority shareholder(s) or the company can sue the majority for damages -the compensation is paid to the company- or can make an application for an injunction.²⁸²

According to the most widely accepted opinion, the company interest as a criterion to determine the fiduciary duties of the shareholder(s) forms only a guideline for the protection of minority shareholders, since constraints on shareholders are not valid for the one-man company and if all the shareholders consent to the measure.²⁸³ The Federal Court (*BGH*) has even stated explicitly that a company interest which is independent of all shareholders and could be a basis for the fiduciary duties of all shareholders towards the company is not to be acknowledged.²⁸⁴ Scholars claim that due to the structure of the *GmbH*, the interest of the shareholders takes precedence over the interest of the company.²⁸⁵ The other opinion also takes the fiduciary duty of the

²⁸⁰ Fiduciary duties of shareholders towards other shareholders are generally accepted since *BGHZ* 65, 15ff. - ITT.; see in general for fiduciary duties in the *GmbH* and the different intensity with which they limit the exercise of shareholder rights Immenga, "Bindung von Rechtsmacht durch Treuepflichten", in Lutter et al. (eds.), *Festschrift 100 Jahre GmbH-Gesetz* (1992), p. 189ff.

²⁸¹ In detail highly controversial, see with further references Emmerich/Sonnenschein (1993), supra note 186, p. 107-110.; Lutter/Hommelhoff, *GmbH-Gesetz* (1991), 13th ed., annex § 13, note 10f.; Emmerich, in Scholz, *GmbH-Gesetz* (1993), 8th ed., Vol. 1., annex "Konzernrecht", note 100-112.

²⁸² Generally accepted since *BGHZ* 65, 15, 18f.; see Emmerich/Sonnenschein (1993), supra note 186, p. 440-444.

²⁸³ Zöllner, in Baumbach/Hueck, *GmbH-Gesetz* (1988), 15th ed., appendix II, note 8; Lutter/Hommelhoff, *GmbH-Gesetz* (1985), 13th ed., annex § 13 note 13; Emmerich in Scholz, *GmbH-Gesetz* (1993), 8th ed., Vol. 1, annex "Konzernrecht", note 113; Flume (1983), supra note 263, p. 128; and see all the scholars in favour of the permissibility of the qualified de facto group with an affiliated *GmbH*, see Emmerich/Sonnenschein (1993), supra note 186, p. 453 footnote 91 with further references.

²⁸⁴ *BGH*, *Neue Juristische Wochenschrift* 1993, p. 194.

²⁸⁵ Flume (1983), supra note 263, p. 61; see, on the other hand, Teubner (1995), supra note 224, who makes a distinction between "normative" and "actual" (enterprise) interest, where the "normative" interest is the same for all legal forms of enterprises, and the "actual" interest depends on the form. However, it is not clear how the "normative" interest should be enforced if the "'actual' interest" inherent in the respective company structure does not provide for the means to enforce it and how the "normative" interest can be established for the *GmbH* (it may be even more difficult for partnerships) if positive law

shareholder(s) to the company seriously and makes allowances for other determinants of the company interest as the interests of the creditors and the interests of the employees, as defined in the codetermination laws and therefore different according to the size of the company. The minimum content of the company interest is the self-preservation of the company according to the interests of both groups of stakeholders.²⁸⁶ The first body of opinion does not find that there are any constraints inherent in the company interest in the use of a *GmbH* as a subsidiary, thus an independent company interest is not deemed to be an indispensable constituent of the *GmbH*. Constraints on the affiliation of the *GmbH* are derived only from the aim of the company interest to protect minority shareholders; however, these constraints will not be dealt with in this study. According to the second body of opinion a self-interest of the company necessarily belongs to the company in the *GmbH* type, but is reduced to the general interest of the company in its self-preservation.²⁸⁷ This does not in principle hinder the use of a *GmbH* as an affiliated company in general; the necessary interest in self-preservation and a certain amount of independence may fit the economic considerations for the relevant interest of a business organisation rather well as shown above. Therefore, the *GmbH* can be used as an affiliated company according to both opinions.

The legal implication of the formation of a legal person is that it is a point of attribution of rights and duties, especially of property rights. The decision whether a social construct is granted legal capacity depends on the positive law and the lawmaker can decide whether or not to grant legal personality. In the same way, the extent of the legal capacity is determined by the positive law²⁸⁸, while the legal capacity of the legal person and its separateness from its members will be limited to the role of the company's legal personality in legal relations, and to the extent to which it is necessary

does not provide for aspects of such a "normative" interest; a deduction from the essence of the company and/or of the legal person may be too abstract.

²⁸⁶ See Ulmer (1984), supra note 274, p. 416-420; Hommelhoff (1982), supra note 15, p. 256; K. Schmidt (1991), supra note 245, p. 1012.

²⁸⁷ Reuter, *Münchener Kommentar zum BGB* (1978), vol. 1, introduction § 21 note 9, also for the consequences of a lack in the self-interest of the legal person

²⁸⁸ There is in general no need to grant the company an unlimited legal capacity as this is given to natural persons, even if traditionally the legal capacity of the legal person is aligned to the legal capacity of the natural person, see Antunes (1991), supra note 19, p. 84.

for its activity.²⁸⁹ In the same way, the limited liability may be limited: limits may derive from the role of this institution in economic activity and from legal elements which form the conditions for the acknowledgement of the limited liability.²⁹⁰

To conclude, the *GmbH* as a legal person is intended to be independent from its members to a certain extent, in the sense of the "ideal whole" of the legal person.²⁹¹ The elements of the legal person are oriented towards a rather independent activity of the company: the legal fixing of an organisational structure, the separating of a fund for the company's activity, and the granting of legal capacity to a separate entity. However, the concrete organisational structure of the *GmbH* does not secure the independence of the company effectively as one of its organs, the shareholder assembly, is given primacy over the other, the directors, by the right to determine the management of the company to a wide extent by means of instructions. Furthermore, the model of the *GmbH* as somehow independent towards its shareholders is in conflict with the use of the company in reality. The *GmbH* is mostly chosen for medium-sized firms in which the shareholders normally know each other and have a strong influence on the way the business is run; often the shareholders also provide the directors of the company. Therefore factual aspects also weaken the separation of company and shareholders. The tension between the general elements of the legal person and the concrete structure of the *GmbH*, including its factual use, can also be seen on the company interest.²⁹² In principle, the (independent) self-interest of the company is approved; however, it is only got into effect if minority shareholders have to be protected by it. A completely detached company interest from its shareholders is not accepted; moreover, it is difficult to see how such an interest could be achieved without the support of an adequate organisational structure. Further limits for the company interest are only favoured to protection of the creditors. In general, autonomy is no longer seen as a decisive element

²⁸⁹ See Westermann, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., introduction note 6; Winter, in Scholz, *GmbH-Gesetz* (1978/80), 6th ed., § 13, note 11-13; Reuter, *Münchener Kommentar zum BGB* (1978), Vol. 1, introduction § 21, note 7f.

²⁹⁰ Winter, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., § 13 note 24f.; Reuter, *ibid.*, note 10.

²⁹¹ See Flume (1983), *supra* note 263, p. 49, with reference to Savigny; also taking up the metaphor of the "ideal whole" Teuber (1988), *supra* note 267, p. 150-152.

²⁹² The same tension can be seen in the legal model of the *GmbH* between limited liability and the dominant position of the shareholders, see Westermann, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., introduction note 1f.

of the legal person.²⁹³

2. The Profit Centre in the Form of a Legal Person and a *GmbH*

In principle, the legal structure of the *GmbH* seems to be very well suited for use as an affiliated company in a group. Especially the right of the shareholder assembly to issue legally binding instructions for the directors allows the group management to exert influence on the subsidiary's management. Thus the business of the *GmbH* can be determined and the management competences of the directors can be limited to a large extent, e.g. shareholders may install reservations of consent for certain management decisions.²⁹⁴ The shareholder assembly also has comprehensive control competences.²⁹⁵ Another advantage of the *GmbH* as a legal form is that there are very few mandatory laws for the design of the company's articles with regard to the internal relationship, so that the articles of the company can be designed very precisely for the purposes of the company, including its position in a group.²⁹⁶ The concrete structure of the *GmbH* is therefore advantageous for its use as a member of a group; the question remains whether the above-described economic organisation of a group is compatible with the elements of the legal person in the form of a *GmbH*. To put it more concretely, what needs to be analysed is whether the elements of the *GmbH*'s legal structure are compatible with the position of a semi-autonomous profit centre which is partly directed and controlled by the strategic group management.²⁹⁷

The profit centres form separate units in the enterprise, as such they are clearly separated from the other parts of the enterprise for economic reasons. This fits the legal status of a company as a separate legal entity. In general, the internal economic organisation can also be adapted to the organisational structure of the company, the management of the profit centre is formed by the directors of the *GmbH*, and the group

²⁹³ See for the legal person in general Reuter, *Münchener Kommentar zum BGB* (1978), vol. 1, introduction § 21, note 9.

²⁹⁴ See Koppensteiner, in Rowedder (ed.), *GmbH-Gesetz* (1985), § 37 note 19-22, 25.

²⁹⁵ *GmbHG* § 46 No 6; cf. Koppensteiner, *ibid.*, § 46 note 27-29.

²⁹⁶ See *GmbHG* § 45.

²⁹⁷ See for a summary of the important factors of this structure B IV.

management or its representatives constitute the shareholder assembly (including, of course, possible minority shareholders).²⁹⁸

The profit centre is also intended to form independent assets, especially as one of the main controlling devices in its structure is the return on investment. Thus it lies in the nature of a profit centre that precisely fixed assets be assigned to it for its disposal as a separate fund. In principle, the requirements of the economic structure with regard to separate assets match those of the legal structure of the legal person as a *GmbH*.²⁹⁹

The profit centre structure attributes to each profit centre a self-interest as otherwise the aims of the actual goal of a profit centre, to make profits for this unit, could not be achieved. The management and the subsidiary are directed and controlled in fact by the profits, so that the self-interest of the unit in the market is kept. On the other hand, the interest and autonomy of the affiliated company are altered in several strategic respects. The group management determines strategic decisions and naturally looks after the interest of the group, especially in the fields of the business activities of the subsidiary, degree of indebtedness, amount of investments, profits to be achieved. In this way, the interests of the subsidiary are transformed by the group: its interest is only pursued in the strategic framework set by the group interest and determined by the group management. The subsidiary/profit centre is granted autonomy within these limits for concrete presence in the market. In fact, the reduced autonomy of the subsidiary's management seems to suit the legal structure of the *GmbH*. The main factor which determines the interest of the company, its profit orientation as an actor in the market, corresponds to the goals and purposes of a profit centre. In the legal structure of the *GmbH*, the actual company interest is very reduced, if there are no dissenting minority shareholders (which will not be assumed here). The strategic heteronomy of the company also seems to lie in the structure of a *GmbH*. The shareholder assembly is given primacy in the structure of the company by its right to issue instructions to the

²⁹⁸ For possible problems with regard to the staffing of the directors, especially interlocking directorates, see below.

²⁹⁹ See for further analysis of the company's separate fund and limited liability below.

directors; therefore, the shareholders normally take the structural/strategic decisions for the company. As the *GmbH* does not form a public company with a normal widespread of shareholders, the influence and the interest of the single shareholder is not neutralized. Therefore the view of the company as a self-sustaining interest and autonomy centre does not greatly correspond to the structure of the *GmbH*. The lack of real autonomy of the *GmbH* as an affiliated company in a group seems to make only a slight difference in comparison to an independent *GmbH*, dominated by a private shareholder; this can also be seen in the reduction of the company interest in the *GmbH* to the interest of the shareholders.³⁰⁰ Nevertheless, it needs to be acknowledged that - besides the lack of structural autonomy to achieve an independently formed company interest- the general interest of the profit centre and that of the company, i.e. to make profits for the unit, match each other.³⁰¹

A main feature of the *GmbH* as a legal person is that legal rights and duties can be attributed to it. The economic structure is formed in such a way that a profit centre has direct access to the market and its purpose is to be directly aligned to it as well as to have a certain independence of standing within it. The profit centre therefore handles all legal relations with the market and according to the economic structure, the consequences of its business activity are to meet itself. The attribution of rights and duties to the *GmbH* as a subsidiary corresponds to the economic structure, which assigns the results of the business activity first and foremost to the unit concerned; the group or the parent as "superior authority" not only uses the subsidiary as a "dummy" or "puppet" behind which the higher levels of the group act as "wire-pullers". Focusing on such a standing of the company does not mean that the affiliated *GmbH* has in all circumstances to be the final point of attribution of rights and -especially- duties, thus that always treating it as a "normal" (i.e. independent) company, but that because the parent exerts influence the need for the attribution of the consequences of this influence

³⁰⁰ See for a different view of the situation of interests in the affiliated *GmbH* in comparison to an independent *GmbH* e.g. Ulmer (1984), supra note 274, p. 396.

³⁰¹ See inhowfar the organisation uses the legally defined company interest for economic reasons B III 3 a; for the dangers caused by the group for the assets of the subsidiary see below.

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to the parent may arise.³⁰²

According to this economic structure, the legal person, in the form of a *GmbH*, can be seen as relativized³⁰³ in a group, as a profit centre standing is assigned to the company with only limited autonomy. Despite the limits on the company's autonomy, the concept keeps the main elements of the legal person; it is seen as a body with its own organisation, assets, and especially its own self-interest necessary which is necessary to form a guideline for the unit as a profit centre. The economic structure needs exactly these attributes for the profit centre units, therefore it exploits the legal organisational structure for its own economic purposes and there is an economic incentive to keep the -legally intended- separateness of the legal person (in the form of a *GmbH*) - within certain limits. Through this economic concept the legal person is relativized and reduced in its function as separate body and autonomous interest centre, but on the relativized level the economic structure maintains the attributes of the legal person - this concept is appropriate for the *GmbH*, as it is already relativized in its legal structure and does not really correspond to the model of the legal person.

3. Personnel Policy

Very important for the enforcement of a uniform group policy is the personnel policy in the group, i.e. the staffing of the subsidiary's management. The shareholder assembly decides about the directors of the company by majority resolution (*GmbHG* § 46 No 5), they are personally dependent on the shareholder assembly and can be removed from their position at any time (*GmbHG* § 37).³⁰⁴ As the parent normally dominates the shareholder assembly, it can enforce its wishes with regard to the staffing of the management and in this way enforce the group policy and largely determine the subsidiary's business policy. Therefore, already with regard to the personnel policy it

³⁰² See for this Teubner, "Die 'Politik des Gesetzes' im Recht der Konzernhaftung", in *Festschrift Steindorff* (1990), p. 261ff.; the same for franchising networks see Teubner, "'Verbund', 'Verband' oder 'Verkehr'?", in *Zeitschrift für Handelsrecht* 154 (1990), p. 295ff., 309ff.

³⁰³ See already for the relativation of the legal person in a group Raiser (1964), *supra* note 2, p. 54.

³⁰⁴ Deviations regarding appointment and removal of the company's directors are possible according to the articles of the company.

is questionable whether the minimum independence of the subsidiary company as a legal form is kept. This area is often also discussed with regard to the following problem, the protection of creditors.

The main problem in this respect are the interlocking directorates. This means that at least one director of the subsidiary is also director of the parent; he therefore has a dual mandate. This may lead to conflicts of interests and duties in the accomplishment of the director's duties with the respective company; or -to express the problem in terms of structure of the company- it may lead to a lack of separation between the interests of the parent and of the subsidiary or to a predominance of the parent interests towards the subsidiary as both directorates are crystallized in one single person.³⁰⁵ As a consequence the prohibition of such a structure and/or the extension of liability are discussed.³⁰⁶

There are no statutory legal provisions which prohibit interlocking directorates, the only rules about the incompatibility of offices refer to members of the supervisory board (*AktG* § 100) and from these provisions nothing can be derived for dual mandates of directors. The question whether interlocking directorates per se distort the structure of the company in a way which is unacceptable is controversial for the *AG*, while for the *GmbH* it is generally accepted that at least partially interlocking directorates are compatible with this company form as the *GmbH* grants the shareholders per se a greater influence on the company.³⁰⁷ The directors are obliged to comply with their

³⁰⁵ Interlocking directorates may cause problems on different levels; the joint conduct of business and joint representation by the directors of the subsidiary and of the parent may be distorted by interlocking directorates and the control of the subsidiary's directors by a supervisory board which consists of directors of the parent may be dubious, see for the arising legal problems in the *AG* Martens, "Die Organisation des Konzernvorstandes", *Festschrift für Heinsius* (1991), p. 525-527; Hoffmann-Becking (1986), supra note 255, p. 571-574.

³⁰⁶ For interlocking directorates as a trigger for the form of the qualified de facto group with an affiliated *GmbH* (*qualifiziert faktischer Konzern*), see Emmerich/Sonnenschein (1993), supra note 186, p. 402f.; for the permissibility of such a form see Emmerich/Sonnenschein *ibid.*, p. 445-449; with regard to interlocking directorates as a trigger for the extension of liability see affirmative Säcker, "Zur Problematik von Mehrfachfunktionen im Konzern", *Zeitschrift für Handelsrecht* 151 (1987), p. 59ff.; contrary to an automatic extension of liability Lindermann, "Doppelmandat gleich Haftungsdurchgriff?", *Die Aktiengesellschaft* 1987, p. 225ff.

³⁰⁷ See even *BGHZ* 115, 187, 195 - Video; Lindermann, *ibid.*, p. 235; in the same direction Säcker *ibid.*, p. 68. The problem is shifted to the question whether the interlocking directorates trigger an extension of liability or are simply a sign of dominant influence.

duties towards both companies, thus they have to pursue the interest of the respective company for which they are acting. Any conflict of interest is mitigated if the parent is the only shareholder, as the subsidiary's company interest can -to a great extent- be determined by the parent.³⁰⁸ Therefore, the exerting of influence in both companies is not necessarily seen as being contrary to the interest of the respective companies and to the duties of the directors, but only inasmuch as the infringement of duties and the damaging of companies leads to an unlawful status.³⁰⁹

This result of the legal discussion can be supported by the objectives of the economic structure. Interlocking directorates are a means for maintaining the subsidiaries in a group with a decentralised group structure. The interest of the subsidiary is to be taken into account in the formulation of the group policy; therefore, in that large area in which group interest and company interest correspond, the interest of the subsidiary can be better seen at the group level, and a further reaching determination of the company interest by a supposed predominant group interest can even be avoided. In organisational respects, interlocking directorates -in a profit centre organisation- are only chosen if the direct integration of the subsidiary's interest has a high significance in the group and if it does not seem to be necessary to formulate the group policy as detached from a direct contribution of the subsidiaries, in order to avoid negotiated compromises in favour of partial interests and to the damage of the overall group policy.³¹⁰

The same conflict reappears with regard to the staffing of the subsidiary's organs with people who "represent" the interest of the parent. The opinion that the parent may not send people who represent its interest in the shareholder assembly does not seem to have been put forward; neither does the opinion that the parent is not allowed to appoint the directors according to its preferences (for the *GmbH*). Doubts have arisen whether -in an *AG*- the parent as a majority shareholder can appoint all the

³⁰⁸ See above C III 1. Similar Hoffmann-Becking (1986), supra note 255, p. 575.

³⁰⁹ See for the *AG OLG Köln ZIP* 1993, 110, 114; with in this respect affirmative comment by Timm, *ibid.*, p. 117.

³¹⁰ See v.Werder (1989), supra note 198, p. 43; see also the example of *Du Pont* above, footnote 110.

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members of the supervisory board or whether neutral people or representatives of minority shareholders are also to be appointed.³¹¹ In principle, the same problem may appear for a *GmbH* with a supervisory board. Direct statutory provisions which object to the appointment of representatives of the parent for the supervisory board cannot be found, as groups in German law are privileged (within groups one person can hold up to 15 seats in supervisory boards instead of 10 in non-associated companies (*AktG* § 100 (2) 2nd sentence)).³¹² Moreover, a partial prevention of the parent's representation in the supervisory board would directly hinder the formation of a group even in a very decentralised form, as the appointment of members of the supervisory board is one of the main factors for achieving a uniform group policy - otherwise the centrifugal forces in a group could prevent a uniform management in the group (especially if representatives of the employees are members of the subsidiary's supervisory board).³¹³ As the simple de facto group is generally seen to be allowed³¹⁴ and the appointment of the members of the supervisory board does not necessarily lead to the total subordination of the company the predominating opinion gives the parent the right to appoint "its" representatives for the organs of the company.³¹⁵

The conclusion that in a group personal links are not per se forbidden can be supported by an examination of other legal orders. In France, legal persons can themselves be members of the administrative board or of the supervisory board of a

³¹¹ OLG Hamm *NJW* 1987, 1030, 1031f. - Banning; and see the proposals by Hommelhoff (1988), *supra* note 257, p. 122-124.

³¹² Similar provisions exist in French law for the appointment of members of the board or the supervisory board of the *société anonyme*, the maximum number of mandates in the organs is more flexible for groups, see *Loi 1966* art. 92, 111, 127, 136 and Ripert/Roblot/Germain (1993), *supra* note 11, note 1270.

³¹³ See as an example the unsuccessful takeover of East-German steel mills by the Italian entrepreneur Riva, one of the reasons for the failure was the wish of the unions to appoint a "neutral" chairman of the supervisory board according to their preferences, *FAZ* from 30 April 1994, p. 14.

³¹⁴ See for an argumentation taking the permissibility of the de facto group as a starting point especially Hommelhoff (1982), *supra* note 15, p. 110-112; for a more detailed analysis with regard to the statutory provisions of the *AG* see Kropff, in Geßler et al. (ed.), *Kommentar zum Aktiengesetz* (1976), § 311 note 7-20. For an argumentation more from the concrete legal norms and not from the general permissibility of the de facto group Emmerich/Sonnenschein (1993), *supra* note 186, p. 376; de facto groups with an affiliated *GmbH* are generally held for allowed see Emmerich/Sonnenschein, *ibid.*, p. 436ff.

³¹⁵ Very critical with regard to the decision of the OLG Hamm Timm, "Grundfragen des "qualifizierten" faktischen Konzerns im Aktienrecht", *Neue Juristische Wochenschrift* 1987, p. 977ff.; Lindermann (1987), *supra* note 306, p. 237ff.

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société anonyme,³¹⁶ in this function they are mostly represented by their directors. In Great Britain, corporate bodies can be appointed as directors so that complete control of a subsidiary is maintained.³¹⁷ According to these legal orders, the parent as director of a subsidiary has to comply with the duties which a director usually has to take care of towards his company; a necessarily appearing, structural conflict of interests is not conceived in this construction by French and English law.

4. Financial Management

The separation of one economic actor into different legal persons with their own equity capital, the possibility to raise credits for each single company on the basis of this, and to grant credits or equity capital from one company to another, changes the financial situation completely from that of a uniform company.³¹⁸ However, the wider possibilities for an abuse of financial means owing to the more complex financial situation in a group will not be examined as in this respect it is only relevant for the study whether and to what extent the form of a *GmbH* as an affiliated company allows the presence of a uniform financial management in the group. The financial management of a group can be more or less centralized, however, the group management has to set certain standards in order to enforce the group policy and to control the financial situation of the group as a whole. The setting of standards as the return on income which is to be achieved by the subsidiary, a certain debt-equity degree which is not to be exceeded, and an endowment with equity capital does not really seem to affect the functioning of the company.

The decision of the group management about the use of the subsidiary's profits (by resolution of the shareholder assembly, *GmbHG* § 46 No 1) can be seen as

³¹⁶ It depends on the concrete structure of the company, for the company with a board system see *Loi 1966* art. 91, in the company with a supervisory board the legal person can be one of its members, but cannot be a director of the company, see for the *Société Anonyme Loi 1966* art. 135 and art. 120 (3) and Ripert/Roblot/Germain (1993), supra note 11, note 1269; the director(s) of a *Société à Responsabilité Limitée* has to be a natural person, *Loi 1966* art. 49 (1).

³¹⁷ See CA 1985 s. 289 (1) b; but this may lead to the liability of the parent in the light of the Insolvency Act 1986 s. 213, 214; see Gower (1992), supra note 9, p. 110-115; 143.

³¹⁸ See for the different possible effects with an ornate terminology Schneider (1984), supra note 205, p. 501-506.

problematic, since it is a decision about whether the profits must be distributed or can be kept. By this the parent can decide about the future investments and future performance of the subsidiary. Using the above-described internal capital market, the group management can distribute the earnings of one group member to another if the projects of the latter promise a higher yield. This may seem to be unfair³¹⁹ as it may be disadvantageous for the subsidiary which has actually made the profit, but in the framework set by the law shareholders are free to use the profits of the company as they wish. Limits especially derive from the fiduciary duties of the parent as majority shareholder towards the *GmbH* and minority shareholders. Fiduciary duties can require that the *GmbH* distributes an adequate part of its profits, but also, on the other hand, that parts of its profits be allotted to the reserves if this is necessary for future investments.³²⁰ However, this problem does not refer specifically to the group but is a general problem of the relationship between majority and minority shareholders; in addition, such fiduciary duties can only be asserted if minority shareholders exist in the *GmbH*. The need of the subsidiary for new equity capital or capital in other forms (e.g. bank loans) is also in the same way treated. The parent, in general, is not obliged to attribute new capital to the subsidiary, at least no more so than any other (majority) shareholder.³²¹ Therefore, in principle, the subsidiary does not have a right to equal treatment with regard to the distribution of financial means, since the parent is free to decide to which subsidiary it wants to allocate further resources.³²²

Greater objections have arisen regarding the centralization of financial functions, such as the centralization of the procurement of capital and -especially- a uniform cash-management. Through measures as these the independent existence of a company can be endangered, especially if the parent and the group as a whole finds itself in financial difficulties, or if the subsidiary is severed from the group. In a decentralised group structure, therefore, only the long-term need for capital is centralized or centrally

³¹⁹ Very critical Antunes (1991), *supra* note 19, p. 114.

³²⁰ See Goerdeler/Welf, in Hachenburg, *GmbH-Gesetz* (1992), 8th ed., § 29 note 62-67, 71-75.

³²¹ See Schneider (1984), *supra* note 205, p. 529; an obligation to allocate capital can derive from the fiduciary duties of the shareholders if for the continued existence of the company an increase of the equity capital is necessary, see Rowedder, in *id.* (ed.), *GmbH-Gesetz* (1985), § 13 note 15.

³²² Schneider, *ibid.*, p. 534f.

directed, as a central long-term financing of this type does not affect the subsidiary to a great extent as the company can take this entrepreneurial function over again in a short time. The absorption of liquidity by a central cash-management causes greater problems, as in the very centralized form of a central cash-management the single company does not have any liquidity at its own disposal; this leads in the case of any financial difficulties on the part of the parent/the group to automatic difficulties for the subsidiary. In a de facto group it is thus absolutely necessary that the subsidiary holds sufficient liquidity at its disposal as otherwise its standing as an entity with a certain interest of self-preservation and with a certain independence cannot be upheld.³²³ The short- and medium-range need for capital must therefore be at least partly covered by the subsidiary itself, and the subsidiary must maintain its own relations with banks, while the parent may support it by giving securities and providing for a uniform banking policy.³²⁴

In general, the *GmbH* should not become totally dependent on the parent in financial respects, thus the centralizing of the financing function and a central cash-management is only to a certain extent compatible with the form of a *GmbH*. Dependence on the parent is especially relevant in times of crisis, but, in normal times also, a complete dependence of the affiliated company in financial respects can lead to a total dependence also in other respects.³²⁵

A related problem is that of the credit ties between companies in a group. Group members can grant each other credits out of their separate funds; thus the group is less dependent on bank loans and is able to economize on interests. The central cash-management provides also a system of credits granting, as the liquidity deficit of some companies is balanced by the surplus of others and some companies thus grant short-range credits to others. In the granting of credits from one company to another several dangers lie. First, the profit centre principle may be distorted if the usual interest rates

³²³ See Schneider (1984), supra note 205, p. 533-535.

³²⁴ Reintges (1988), supra note 184, p. 677-679; Schneider, *ibid.*, p. 498f.

³²⁵ cf. considerations by Goerdeler/Welf, in Hachenburg, *GmbH-Gesetz* (1992), 8th ed., § 29 note 75.

5. Accounting and Information

One important device to form a unified group management is that of the informational ties between the companies in the group, by a group-wide uniform accounting and auditing procedure and by more informal informational links, such as meetings, committees, and the distribution of plans and programmes. If the information is necessary for drawing up consolidated group accounts, the subsidiary is explicitly obliged by statute to deliver the information (*HGB* § 290 (3)).³³⁰ Moreover, in the *GmbH*, a comprehensive right of information is granted to all shareholders (*GmbHG* § 51a), and thus the parent can demand also information from the subsidiary.³³¹ As a further justification for the informational flow between parent and subsidiary, the permissibility of the de facto group is in general used.³³² Nevertheless, as these informational and coordinative links do not really touch upon the independent activity of the subsidiary and no objections arise directly from the statutory provisions³³³ these elements of the economic organisation are compatible with the legal concept of the *GmbH*.

6. Shift of Entrepreneurial Functions from the Subsidiary to Other Group Members

A further measure which can endanger the existence of the company as an enterprise is the shift of entrepreneurial functions away from the subsidiary - by centralization at the level of the parent or by attribution to a subsidiary. By centralizing functions the affiliated company may become dependent on the parent or other subsidiaries if it is not able to run its business without the entrepreneurial function taken over by the other group members. In particular, the company may be affected by the consequences of a

"Einige Elemente der konzernrechtlichen Sonderregelungen in Frankreich", in Mesimäcker/Behrens (eds.), *Das Gesellschaftsrecht der Konzerne im internationalen Vergleich* (1991), p. 184f.

³³⁰ See also the exception from the equal treatment of all shareholders of an AG with regard to information *AktG* § 131 (4) 3rd sentence.

³³¹ cf. Hüffer, in Hachenburg, *GmbH-Gesetz* (1991), § 51a note 31.

³³² Krieger, in *Münchener Handbuch der AG* (1988), § 69 note 33 with further references; Scheffler (1991), *supra* note 195, p. 259.

³³³ More difficult is the situation in the AG as *AktG* § 131 (4) 1st, 2nd sentence and § 93 (1) 2nd sentence seem to be rather contrary to such an interpretation.

crisis of the parent or the other group member. The solution for this case must be the same as that used in the centralization of the financial management, that is to say, functions may be centralized as long as the company does not become completely dependent on the group or as long as the function can be built up again if necessary - i.e. in the case of a crisis in the group or if the group integration of the company is dissolved. This also corresponds to the economic requirements of a profit centre, as whoever takes the responsibility for the profit must have those competences in order to determine all the elements which are relevant for the profit; a coerced centralization of functions without other alternatives may lead to a distortion of the profit centre result. However, this problem may have become less acute since over the few last years, due to the formula "lean management and production", it has become normal for companies to shift entrepreneurial functions to other enterprises - such a shift must also be possible in the group and the subsidiary is secured as there has arisen a market for these functions.

7. Conclusion

The standing as a profit centre is compatible with the form of a legal person and the company form of a *GmbH*. The status of the *GmbH* is maintained in the economic structure with regard to all aspects of the legal person; it has its own organisation, its assets are separated from the assets of other companies in the group, and an interest is attributed to the company as a profit centre. Especially with regard to the latter element, the transformation of the company in a group can be seen: the company interest is no longer autonomously determined within the company, but a pecuniary interest is attributed to the company within the framework of the group interest. In this way, the legal person is also relativized in other aspects, since the *GmbH* is given a semi-autonomous and semi-independent status; however, such a relativized legal person is needed by the economic structure in order to exploit economic objectives. The means of achieving unified management are in general compatible with the legal structure of the *GmbH*, limits on the single devices derive from the necessary degree for an independent existence of the corporate body - these devices may not lead to a complete absorption of the *GmbH* in a group, and special precautions may have to be taken for

the case of a crisis of the group or of a detachment of the company from the group.

IV. Extension of Liability in a De Facto Group With Affiliated *GmbH*

*"There is no such thing as unlimited liability."*³³⁴

A further point to examine is the position of the creditors in a de facto group with an affiliated *GmbH*. The position of the creditors is to analyse with regard to efficiency - as it has been done for the organisation of a group and its legal limits through the concept of the company. In order to judge the efficiency of the creditors' position, it has to be decided whether the safeguards for the creditors established by company law also cover the risks arising from a group structure, or whether the creditors have to face unpredictable risks or to bear externalities caused by the group structure, thus necessitating additional safeguards. Dangers for the creditors may derive on two levels from the structural changes which the group causes for the legal concept of the company. First, the group may render the provisions which establish the legal person as a separate body with the attributes mentioned above ineffectively. These provisions of organisational law are to some extent linked with the limited liability of the company and serve to protect the creditors. Second, the provisions for the separate patrimonial fund of the company may be undermined by the group structure.

The protection of creditors in a group will be studied according to the recent jurisdiction of the *Bundesgerichtshof* (*BGH*), according to which the liability for an affiliated *GmbH* can be extended to the parent if a qualified de facto group (*qualifiziert faktischer Konzern*) is formed. By defining such a special group organisation, the *BGH* draws a line beyond which the limited liability of the subsidiary is eliminated and liability is extended to the parent. It will be proposed that the extension of liability to the parent can be defined along the lines given by the above-described economic organisational model.

³³⁴ Woodward, "Limited Liability and the Theory of the Firm", *Journal of Institutional and Theoretical Economics* 141 (1985), p. 610.

The negative effects which these decisions have brought about in the business world affected³³⁵ also underline the necessity for a clear-cut limitation for an organisational group structure, compatible with the company law concept and preserving the limited liability of the single company. The business practice needs security with regard to the legal consequences which a chosen group structure may have - as well as in regard to liability questions. Only once it has this security can the parent predict the risk it runs with the formation of a group, align its behaviour towards the affiliated company according to the criteria which cause an extension of liability, and determine which legal group structure fits its organisational preferences, and, therefore, whether it must place the group on a control contract if the organisational concept is not compatible with a *de facto* group. Hence, an efficient organisational structure for the group not only requires that it be possible to perform a minimum of unified management over the group members, but also that the consequences of such a group structure with regard to liability be predictable. These two variables, security and predictability, therefore form part of the efficiency of the organisational structure.

In a second step, the result will be examined with regard for the economic considerations for limited liability. On the one hand, the necessity for an extension of liability to the parent is disputed as this function can be taken over more efficiently by the market. On the other, it is doubtful whether there still is a rationale for the limited liability of a single company in a group. This means that within a group there are barriers of liability and the question is whether -in the absence of any justification for the privilege of limited liability for group members- the parent or the whole group should be liable for the debts of each of its members (in which dogmatic way soever this result is achieved).

³³⁵ cf. e.g. Wassner, "Ein Schatten mit beschränkter Haftung", *FAZ* from 6 December 1993, p. 15; K.Schmidt, "Zum Stand des Konzernhaftungsrechts bei der GmbH", *ZIP* 12 (1991), p. 1329, "out of wide parts of the medium-size industry would be made an empire of qualified *de facto* groups"; Lutter, "Das System des GmbH-Konzernrechts", in Hommelhoff et al. (eds.), *Der qualifizierte faktische GmbH-Konzern* (1992), p. 196, "presumption of dishonest behaviour for wide parts of the German medium size industry in the form of GmbHs".

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1. Concept of the Qualified De Facto Group According to the *BGH*

In general, the *GmbH* is a company with limited liability; thus it is only the assets of the company which are liable for the debts of the company, and its shareholders are not responsible for the debts of the company if the equity capital is fully paid (*GmbHG* § 13). This is also valid for companies or enterprises as shareholders of an affiliated *GmbH*, since they are not automatically responsible for the debts of the subsidiary. However, the *BGH* fixes a liability of the parent enterprise for the debts of an affiliated *GmbH* in qualified de facto groups. This solution is achieved by a (partial) analogy to the provisions for groups, in which the affiliation of an *AG* is based on a control contract (*AktG* §§ 302, 303).³³⁶ Thus, the parent is directly liable to the creditors of the subsidiary *GmbH* if the subsidiary is wound up and there are no bankruptcy proceedings owing to the lack of property of the bankrupt company (according to *AktG* § 303). Otherwise, the parent meets only an internal obligation to make good the losses of the subsidiary (*AktG* § 302), and this claim can be put forward by the official receiver. The exact extent to which the parent is liable is still under discussion³³⁷; however, in principle it can be said that in a qualified de facto group the parent has to take over the subsidiary's losses or is directly liable for its debts.³³⁸

To assume a group -also a qualified de facto one- presupposes that the dominant shareholder is an enterprise (*AktG* § 18); being an enterprise is therefore a condition for the extension of liability. However, a natural person can also be an "enterprise" in this sense if other business activities are pursued beside the running of the business of the *GmbH* at hand.³³⁹

³³⁶ See *BGHZ* 95, 330, 346-348 - Autokran; *BGHZ* 107, 7, 15ff. - Tiefbau; in the former decision also an analogy to *AktG* § 322 was touched upon, but in later decisions it was no longer considered, cf. the considerations by Stimpel, "Haftung im qualifizierten faktischen Konzern", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 20 (1991), p. 145f.

³³⁷ e.g. for one-man companies as subsidiaries, see in detail for all contested problems Assmann (1992), *supra* note 244, p. 704ff.; Stimpel (1991), *ibid.*, p. 156ff.

³³⁸ Very straight forward in this respect without leaving room for exceptions K. Schmidt, "Verlustrückstellung im qualifizierten faktischen Konzern", in Hommelhoff et al. (eds.), *Der qualifizierte faktische GmbH-Konzern* (1992), p. 109ff.

³³⁹ See for the broad definition of "enterprise" in this respect *BGHZ* 95, 330, 337 - Autokran; *BGHJZ* 1993, 575, 577 - TBB; proceeding from *BGHZ* 69, 334, 337f. - Veba; critical K. Schmidt, "'Konzernhaftung' nach dem TBB-Urteil - Versuch einer Orientierung", *ZIP* 14 (1993), p. 550f.

In principle, the *BGH* does not subject all groups with an affiliated *GmbH* to an extension of liability but only qualified de facto groups; qualified de facto groups therefore have to be defined more narrowly than simple de facto groups - for which a unified management is the criterion.³⁴⁰ The main problem regarding qualified de facto groups is therefore to delimit them from simple de facto groups - this has to be done by bearing in mind the drastic consequences of a qualified de facto group, that is the extension of liability to the parent.³⁴¹ Thus, in principle, the declaring of a group to a qualified de facto group should be the exception, while the simple de facto group should be conceived as the rule. The difficulty of delimiting qualified de facto groups can already be seen in the difficulty of defining a group - within the vague definition of the group by the term "unified management", a further distinction of which has to be made in order to determine the qualified de facto group.

In order to delimit the qualified de facto group several criteria are used - often side by side. The common starting point is the definition of the *Arbeitskreis GmbH-Reform* from 1972, according to which the qualified de facto group is characterised by a serious -that is, substantially comprehensive and temporarily continual- impairment of the self-interest of the affiliated company.³⁴² The serious impairment of a company's self-interest is presumed for every group, therefore the presumption of a qualified de facto group is dependent on a unified management as the constituent of the group. Whereas this presumption can be refuted, the *Arbeitskreis* sets up further factual presumptions which cannot. These presumptions are so far-reaching that it is impossible to conceive a group organisation which does not form a qualified de facto group.³⁴³ The *BGH* jurisdiction took this definition as a starting point in its first relevant decision

³⁴⁰ According to *AktG* § 18 which is valid also for the *GmbH*; for a view which tends to tie the extension of liability on the unified management in a group see Ulmer, "Vermutungs- und Beweisfragen: Qualifizierungsvermutung; Kausalitätsgegenbeweis", in Hommelhoff et al., *Der qualifiziert faktische GmbH-Konzern* (1992), p. 77f..

³⁴¹ To a qualified de facto group further consequences may be also tied, especially with respect to the protection of minority shareholders, see Lutter, "Der qualifizierte faktische Konzern", *Die Aktiengesellschaft* 1990, p. 181f.

³⁴² *Arbeitskreis GmbH-Reform, Thesen und Vorschläge zur GmbH-Reform* (1972), Vol. 2, p. 49f., 59, 67.

³⁴³ *Arbeitskreis GmbH-Reform* (1972), *ibid.*, p. 59f., 68.; see the assessment of these proposals by Deilmann, *Die Entstehung des qualifizierten faktischen Konzerns* (1990), p. 59-61.

- the *Autokran* decision from 1985.³⁴⁴ To the continual and comprehensive management of the parent the *BGH* connects a factual presumption that the interest of the affiliated companies in a group is neglected and that their business activity is determined by the group interest. The parent can refute this presumption by showing that the director of an independent *GmbH* acting according to his duties would have run the company's business in the same way.³⁴⁵ In this judgement as a point of comparison the department of a single enterprise is also presented; according to this criterion, which is often used among scholars, a qualified *de facto* group is given if the *GmbH* is run as the department of a single enterprise.³⁴⁶

In the second decision -the so-called *Tiefbau* decision from 1989- the *BGH* no longer stresses the interest criterion, but adheres to the criterion which serves as a presumption, the continual and comprehensive performance of management, and holds it sufficient for this criterion if a centralized management in the financial area is formed by the dominant enterprise.³⁴⁷ However, the *BGH* alters the way of disproving this presumption, which can be refuted if the dominant enterprise shows that the losses are not caused by the direction of the parent's management but by other causes.³⁴⁸

In the next decision -the so-called *Video* judgement from 1991- the *BGH* focuses more on the dangers for the affiliated company caused by putting aside the interest of the company in favour of the group interest. If the dominant enterprise performs a comprehensive management of the affiliated *GmbH*, the putting aside of its interest is presumed (as in the *Autokran*-decision) and also the parent's management as the cause for the *GmbH's* losses.³⁴⁹ A decisive step is made in this decision as for the (at least) majority shareholder and only director of a *GmbH* who also runs another business the above-stated presumption is valid; thus, he is seen to perform a comprehensive (group-) management of the affiliated *GmbH* and it is presumed that the

³⁴⁴ BGHZ 95, 330ff. - Autokran.

³⁴⁵ BGHZ 95, 330, 344 - Autokran.

³⁴⁶ See BGHZ 95, 330, 341, 344f. - Autokran; regarding this criterion with further references see Deilmann (1990), *supra* note 343, p. 62f.

³⁴⁷ BGHZ 107, 7, 18, 20 - Tiefbau.

³⁴⁸ BGHZ 107, 7, 19 - Tiefbau.

³⁴⁹ BGHZ 115, 187, 193f. - Video.

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interest of the affiliated *GmbH* is put aside.³⁵⁰ The (theoretical) possibility of refuting this presumption is sustained with the same criterion as in the *Tiefbau* case; in addition, interesting remarks are made about what can be alleged to refute the presumption. The presumption cannot be refuted by showing that the company is gone bankrupt because of normal business risks, only by demonstrating that the losses of the *GmbH* are caused by exceptional circumstances - the normal economic risk is therefore in any case shifted to the parent.³⁵¹ As it seems to be impossible for the dominant enterprise to avoid such a succession of presumptions, the decision in fact installs a liability for the majority shareholder and only director of an affiliated *GmbH* if he also runs another business.³⁵²

In its fourth and to date final relevant decision -the so-called *TBB* case from 1993- the *BGH* corrects the liability concept. The reason for the liability of the parent enterprise is no longer primarily seen in the comprehensive and continual performance of management. Liability is accepted if the dependent company is treated in a way which shows an objective abuse of the position of the shareholder. This is the case if the dominant enterprise performs the (group-) management in such a way as to not adequately take the interest of the affiliated *GmbH* into consideration, without allowing the possibility of isolating disadvantages for the *GmbH* caused by single measures and compensating them individually. Adequate consideration for the interest of an affiliated company is lacking in the case of a one-man company if the company cannot settle its debts because of the influence exercised in favour of the group interest. The *BGH* stresses that the reason for the liability cannot be found in the performance of continual and comprehensive (group) management, from this not even a presumption for an inadequate consideration of the interest of the affiliated *GmbH* can be derived. The plaintiff has to assert and to prove facts according to which it seems to be plausible that the management has impaired the interests of the *GmbH* in favour of the group interest beyond any single disadvantages which can be concretely compensated.³⁵³ This is

³⁵⁰ BGHZ 115, 187, 195 - Video.

³⁵¹ BGHZ 115, 187, 196f.- Video

³⁵² See for this nearly inescapable chain of presumptions especially Altmeppen, "Grenzenlose Vermutungen im Recht der GmbH", *Der Betrieb* 44 (1991), p. 2225ff.

³⁵³ BGH *Juristenzeitung* 1993, p. 578 - TBB.

especially the case if the interferences on the part of the parent lead to a confused situation with regard to the patrimonial status of the affiliated company.³⁵⁴ In the case at hand the *BGH* does not deem a central cash management to be sufficient for accepting a qualified de facto group - even if the company assumes responsibility for the debts of other group members as long as the debts of each company can be attributed precisely and the risks caused by assuming liability for other group members' debts are secured by reserves in the balance sheet. The latter condition must only be complied with if the obligations for other group members have become so important as to directly affect the patrimonial situation of the company.³⁵⁵

Also in the last decision the criterion which is mainly used among scholars is touched upon. That is, the status of a qualified de facto group is given if the control and influence of the dominant enterprise have reached such an intensity that single -harmful- measures can no longer be insulated.³⁵⁶ The reason for this criterion is found in the no longer working of other compensation mechanisms. The compensation system of the *AktG* §§ 311-318 for de facto groups with an affiliated *AG* can no longer be applied as it is only orientated towards single interferences which can be estimated.³⁵⁷ This argument is sometimes also used for the *GmbH*³⁵⁸; however, it seems to be closer to the structure of the *GmbH* to focus on the compensation mechanism of the *GmbH* itself which compensates harm caused by the (majority-) shareholder and dominant enterprise via imposing fiduciary duties.³⁵⁹ This scheme also only works for single interventions whose harm can be estimated.³⁶⁰ However, this criterion is also capable of interpretation: instead of focusing on the possibility of compensating harmful interventions, the density of interventions can be deemed to be the main point of this criterion and therefore the total loss of (management) autonomy of the *GmbH*.³⁶¹

³⁵⁴ *BGH* *ibid.*, p. 577, 578 - TBB.

³⁵⁵ *BGH* *ibid.*

³⁵⁶ See Emmerich/Sonnenschein (1993), *supra* note 186, § 20 IV 2; Deilmann (1990), *supra* note 343, p. 63-65; K. Schmidt (1991), *supra* note 245, p. 1018; comprehensively Hoffmann-Becking (1989), *supra* note 255, p. 69, 73ff.

³⁵⁷ cf. only Hommelhoff (1982), *supra* note 15, p. 138ff.

³⁵⁸ Deilmann (1990), *supra* note 343, p. 63-65.

³⁵⁹ See for this system above C III 1.

³⁶⁰ Also *BGH Juristenzeitung* 1993, p. 577 - TBB.

³⁶¹ See for such an interpretation of the criterion K.Schmidt (1991), *supra* note 245, p. 1018.

Various criteria have therefore been used to describe the qualified de facto group.³⁶² The two main criteria seem to be the comprehensive and continual management of the subsidiary by the top of the group and the neglecting of the affiliated company's self interest. The criterion which compares the *GmbH* with the department of a single company can be viewed as a particular form of the parent's management or the organisation of the group.³⁶³ With regard to the final criterion mentioned above, the density of the parent's management is such that a compensation of single (harmful) interventions is impossible, also the considerations about the extent of the parent's management play the most important role. The description of the phenomenon "qualified de facto group" is made even more difficult as in the first three judgements the criteria are combined in a complex way. In these judgements, a so-called *Doppeltatbestand* is constructed, whose main criterion can be seen in the comprehensive and continual (group-) management even if it only forms a presumption for the substantial element of the liability preconditions, that is the neglecting of the affiliated company's interests. The presumption, on the other hand, can again be rebutted by several elements (see the criteria stated above in the *Autokran* and *Tiefbau* cases) which neither directly refer to the criterion for the presumption nor to the substantial criterion.³⁶⁴ In the last decision only the criterion focussing on the neglecting of the subsidiary's interests remains, the comprehensive and continual group management no longer forming a presumption for neglecting the self-interest of the affiliated company, but only a (not crucial) indication.³⁶⁵ This simplification and, at the same time, the more narrowly defined conditions for establishing a group liability have found consent among scholars; the interest formula as crucial means for assuming

³⁶² There is agreement that the elements used to define the qualified de facto groups still lack clarity, see Zöllner, in Baumbach/Hueck, *GmbH-Gesetz* (1988), 15th ed., annex Konzernrecht, note 30; Kübler, "Haftungstrennung und Gläubigerschutz im Recht der Kapitalgesellschaften", *Festschrift für Heinsius* (1991), p. 423; Westermann, "Der Tatbestand des qualifizierten faktischen Konzerns", in Hommelhoff et al., *Der qualifizierte faktische GmbH-Konzern* (1992), p. 39f.

³⁶³ Interpreting the criterion in the same way by K. Schmidt, "Verlustrückstellungspflicht und Konzernleitungshaftung im qualifizierten faktischen GmbH-Konzern", *ZIP* 10 (1989), p. 549f.

³⁶⁴ See for criticism and clarification of the underlying concepts Stodolkowitz, "Die Haftung im qualifiziert faktischen GmbH-Konzern nach der Rechtsprechung des BGH", *ZIP* 13 (1992), p. 1524f.

³⁶⁵ See the authoritative interpretation of the *BGH* concept by one of the judges Stodolkowitz (1992), *ibid.*, p. 1519, 1522; and see in this respect the very clear statement of the remark to the *TBB* decision by Lutter, "Anmerkung zur TBB-Entscheidung", *Juristenzeitung* 1993, p. 581.

the parent's liability has also been welcomed.³⁶⁶ As the formula of the "comprehensive and continual management" has been used in practice this new condition for assuming liability has surely to be assessed positively. According to the (contested) dominant opinion, if at least the financial area is centralized "unified management" as required for the definition of a group in *AktG* § 18 (1) is given;³⁶⁷ according to the *Tiefbau* decision this leads at the same time to a qualified de facto group, which assumes the liability of the parent for the debts of the subsidiary. Accordingly, every group seems already to entail the conditions for a qualified de facto group. Nevertheless, since the very abstract criterion which also focuses on the neglecting of the subsidiary's interest needs to be defined more precisely, the question remains whether by doing that the constituent for defining a group - a unified management over members - can be dismissed so easily.³⁶⁸

The general concept of the *BGH* has been interpreted by scholars in different ways - altering according to the differing approaches of the *BGH*. One body of scholars puts forward the interpretation of assuming the parent's responsibility as liability for an (illegal) conduct of business.³⁶⁹ The justification of the liability is seen in the harmful putting aside of the interest of the affiliated *GmbH* in favour of the group interest by acts of the parent. The focus of this opinion lies on the impairment of the company's interest and of the company itself. The parent is only held liable if it has infringed its duty for a proper group management.³⁷⁰ The other approach views the trigger for an extension of liability on the parent as lying in the organisational status - if the group management exceeds a certain degree of intensity. Damages of the affiliated *GmbH*,

³⁶⁶ See previous footnote and the summary of the "Heidelberger Konzernrechtstage" by Kleindieck, "Haftung im qualifizierten faktischen GmbH-Konzern", *GmbH-Rundschau* 1992, p. 575, 583; Westermann, "Das TBB-Urteil - ein Neuansatz bei der Haftung wegen qualifizierter faktischer Konzernierung?", *ZIP* (14) 1993, p. 556; K.Schmidt (1993), supra note 339, p. 551; Ulmer (1992), supra note 340, p. 70, 74.

³⁶⁷ See Koppensteiner, *Kölner Kommentar zum Aktiengesetz* (1988), 2nd ed., § 18 note 20f.

³⁶⁸ See also the not very enlightening considerations by Stodolkowitz (1992), supra note 364, p. 1522, by which other factors the high degree of central management which now only serves as an indication could be completed or substituted.

³⁶⁹ Interpreting the two first decisions of the *BGH* according to the two different concepts K. Schmidt, (1989), supra note 363, p. 545ff.

³⁷⁰ Lutter/Hommelhoff, *GmbH-Gesetz* (1991), 13th ed., annex § 13 note 16; Lutter (1990), supra note 341, p. 182f.; id. (1993), supra note 365, p. 580f.

caused by the parent in favour of the group, are not required in order to assume the liability of the parent. According to this concept, the parent is held liable for the risks and dangers which it produces for the affiliated company by a high degree of centralized management, making it impossible to control single interferences.³⁷¹ This opinion is criticized as introducing a strict liability without any statutory basis.³⁷² An opinion lying in between these two holds a high degree of centralized management in a group for sufficient as extending the liability on the parent, but leaves the parent the possibility to prove that it is not responsible for the losses of the subsidiary.³⁷³ It is not the goal of this analysis to assess whether these concepts fit the *BGH* jurisdiction; however, the way in which they form a basis for establishing a special group liability will be assessed below.

2. Legal Rationale for a Special Group Liability

The diverse formulas for the qualified de facto *GmbH* group and their interpretation in different concepts display uncertainty about the justifications for a special group liability; according to the different criteria for establishing the parent's liability, the rationales for a special group liability may also vary. The crucial question remains why the safeguards of the company law concept for the protection of creditors no longer function in -certain- group organisations, described as qualified de facto domination, so that as a radical solution the extension of liability to the parent is required. By ascertaining the underlying rationale for establishing a group liability, the criteria for defining the qualified de facto group can also be assessed.

In its judgements, the *BGH* refers very generally to the conflict of interests which is typically inherent in the group for the court. In an independent company the interests of all the company, the shareholders and -at least partly- the creditors are orientated towards a well-being of the company, whereas a dominant enterprise -

³⁷¹ See K. Schmidt (1991), supra note 335, p. 1328f.; Assmann (1992), supra note 244, p. 698-703; Deilmann (1990), supra note 343, p. 125-127, 158-160.

³⁷² Stodolkowitz (1992), supra note 364, p. 1521; Westermann (1993), supra note 366, p. 556.

³⁷³ See Ulmer, "Verlustübernahme als konzernspezifischer Kapitalerhaltungsschutz", *Die Aktiengesellschaft* 1986, p. 128.

including a dominant shareholder with further business interests- may line up the company's business with its other entrepreneurial interests.³⁷⁴ In the final judgement (*TBB*), the *BGH* states the underlying reason more cautiously. The court still acknowledges the danger of a conflict of interests in the group, but recognizes the need for a special group liability only in circumstances in which the situation, because of the intensive influence of the parent, has become so unclear that individual interventions can no longer be insulated.³⁷⁵ These statements may seem to show the way for justifying an extension of liability to the parent; however, they are too general and, in their description of the structural dangers for legal concepts caused by the group, too uncertain to form a basis to define the particular form of group for which a special group liability seems to be necessary.

Yet another approach seeking a legal rationale to holding the parent liable in a qualified de facto group with an affiliated *GmbH*, examines the provisions which establish the liability of a parent in a group based on a control contract in the *Aktiengesetz* and which are applied in analogy for the qualified de facto group. The crucial points in these provisions are the right of the parent to issue (even harmful) instructions to the subsidiary and therefore to exercise a highly centralized management (*AktG* § 308), and the right of non-complying with the provisions for the maintenance of capital of the subsidiary (cf. *AktG* § 291 III) - these rights being connected with the duty of the parent to balance the annual losses of the subsidiary (*AktG* § 302). In its first three decisions, the *BGH* tries to develop the elements for holding the parent liable in a de facto group through the relation between these aspects for the law of a contract-based group.³⁷⁶ However, it seems to be difficult to derive exact requirements for the parent's liability in a de facto group (the requirements of "qualified de facto domination") in comparison to these elements of liability in a contract-based group. First, in agreeing on a control contract it is not a certain (e.g. highly centralized)

³⁷⁴ BGHZ 95, 330, 334f. - Autokran; BGHZ 115, 187, 190 - Video; in the decision BGHZ 107, 7ff. - Tiefbau- considerations about the rationale are not made.

³⁷⁵ BGH, *Juristenzeitung* 1993, p. 577 - TBB.

³⁷⁶ BGHZ 95, 330, 343 - Autokran; BGHZ 107, 7, 17 - Tiefbau; BGHZ 115, 187, 193-195 - Video; see for the way how to draw the analogy the authoritative interpretation of the judgements by the former judge of the *BGH* Stimpel (1991), supra note 336, p. 151-154.

organisational structure which is fixed but only the right to issue instructions which is given to the parent, so that it cannot be ascertained that according to the purpose of the law a specific organisation shall trigger off an extension of liability. Second, the dangers which the provisions for the contract-based group presume to be inherent in this organisational structure and which make a group liability necessary are not concretized in this concept, so that an easy transfer of these considerations does not seem to be possible. In addition, since these elements derive from the law of the *AG*, it is necessary to adapt them to the different structure of the *GmbH* afterwards. Therefore, as with regard to the legal elements of the liability the analogy seems to be somewhat artificial³⁷⁷, it does not seem to be convincing to determine the legal rationale of an extension of liability only with respect to these provisions. The analogy seems to be more useful with regard to the shaping of the details of the extension of liability as a legal consequence.³⁷⁸ Therefore, it may be more fruitful to make recourse to the general rationale for introducing a group liability³⁷⁹; the reasons for the legislator to establish such a liability in the law for the contract-based group will be embraced. The general rationale has to be applied to the law of the *GmbH*; thus it has to be ascertained at which point the general legal reasons require the setting-up of a group liability for an affiliated *GmbH*, as the legal concept of the *GmbH* does no more offer sufficient protection for creditors.

The justification for a special group liability has to start with the concept of limited liability in general.³⁸⁰ The concept of limited liability can be divided into two areas, the legal precautions for limited liability as a feature of the company and legal person and the general economic rationale for limited liability. At this point, the legal provisions will be examined, while the economic rationale will be focused on below. The group structure may affect the provisions for the protection of creditors as these

³⁷⁷ For a critical assessment of the analogy to the *AktG* in this way see Wiedemann (1986), "Spätlese zu Autokran", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 15 (1986), p. 659f.; already doubtful with regard to the construction of a double analogy K. Schmidt (1981), *supra* note 217, p. 472; confirming *id.* (1989), *supra* note 363, p. 547.

³⁷⁸ cf. K. Schmidt (1992), *supra* note 338, p. 117ff.

³⁷⁹ For establishing an open abstract legal principle as better methodological basis for an analogous application of the liability provisions for the contract based group Wiedemann (1986), *supra* note 376, p. 659f.

³⁸⁰ cf. for this starting point also Wiedemann, *ibid.*, p. 670.

provisions are based on the organisational and patrimonial autonomy of the company, and since the group management -as the constituent of the group- limits the autonomy of the affiliated company.³⁸¹ In concreto, the company law concept which secures the organisational independence of the legal person and the provisions which guarantee the separate fund of the company, especially those which are concerned with the maintenance of the equity capital, may be affected by the group structure. The organisational law -here in the form of a *GmbH*- is connected with the limited liability with which the legal person is endowed, and the provisions guaranteeing the maintenance of capital stand in a direct correlation to the limited liability of the company. These provisions in the law of the legal person *GmbH* have to be examined, with regard to which kind of group organisation they lose their efficacy and, thus, for which kind of group organisation they do not provide for sufficient protection of the creditors - as a point of comparison the legal model of an independent *GmbH* will be used in the way this company form is used in economic reality.

a. Protection of the Creditors by Organisational Law

The organisational law of the legal person is also relevant for the protection of the creditors. The law of the *GmbH* does not only erect a separate body, designed to be organisationally independent from its members, in order to establish a legal person as a point of attribution of rights and duties, but this legally constructed body also plays a role in the external relations of the company, with regard to the protection of the creditors. The separate body forms a basis for the limited liability of the *GmbH*. Therefore the extension of liability to the shareholders/to the parent often uses the same criteria as for the -above discussed- question whether the requirements of the legal

³⁸¹ See for a general list for special risks for creditors in a group Landers, "A unified approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy", 42 *University of Chicago Law Review* (1975), p. 596f.

person are kept.³⁸² This task of the concept of a company may be structurally affected by the group form causing the -already mentioned- group conflict. This conflict of interests is normally described for the public company in German law for the AG.

The most important change of the company structure for the creditors seems to come from the transformation of the company interest in the group.³⁸³ The company interest forms the guideline for the whole business activity of the company, and it makes available a standard by which to measure the liability of the directors as well as the validity of shareholder resolutions. The primary content of the company interest is the profit maximizing principle which is designed to assure the continued solvency of the company and to lead to the growth of assets and to the distribution of dividends. Thereby, the interests of the shareholders and of the creditors are parallel, since pursuing the company interest serves both the interests of the shareholders and those of the creditors.

The company interest is not seen as being influenced by special interests; the law of the public company presumes that an independent legal personality is based on economic independence. The public company is conceived as having a widespread circle of shareholders who have only very limited possibilities of influencing the company, by exercising their rights in the shareholder assembly. Common to all shareholders is the wish to realize their proprietary interest in the company, but they do not have the power to pursue and to enforce special -personal or entrepreneurial- interests; therefore, they are interested in the company only as a financial investment and their interests are more or less parallel. Conflicts between the shareholders are solved by the majority principle, and it is assumed that changing majorities lead to fair results. The management, as the centre of power in the company, lies in the hands of the directors (*Vorstand*) and is directly responsible for pursuing the company interest. As the directors are independent from the shareholders and direct the business under

³⁸² See the discussion about piercing the corporate veil, in general Reuter, *Münchener-Kommentar zum BGB* (1978), Vol.1, introduction § 21 note 10ff.; for the *GmbH*, Westermann, in Scholz, *GmbH-Gesetz* (1978/83), 6th ed., introduction note 5f.

³⁸³ See for the transformation of the company interest in the group especially Immenga (1985), supra note 160, note 3; Druey (1980), supra note 14, p. 303-313;

their own responsibility (*AktG* § 76), they are able to manage the company autonomously within the limits given by the company interest. In this respect, it is assumed that the company is economically independent, and that the independent legal personality is based on economic independence. This is the positive side of the separation of ownership and control as one of the features of the public company. Hence, the crucial point in this model is that the *AG* is seen to have no dominant shareholder who can pursue a special interest in the company whereas the the directors manage the company autonomously and are bound to the company interest so that the interests of both the shareholders and the creditors are promoted. Nevertheless, it should be borne in mind that this description represents only an ideal model, which depends on the factual condition that the shareholders are widespread; the structure of the company also makes the dominant position of a majority shareholder possible.³⁸⁴

Typical dangers for this system of relatively harmonious interests arise if the company becomes a subsidiary of a group. The parent enterprise, as the dominant shareholder, is able to influence the business of the company. The directors of the company are no longer independent, only responsible to the assembly of the small shareholders and only bound to the company interest, although they depend on the dominant enterprise. While the company is included into the unified management of the parent, ownership and control are -in this sense- no longer separated. This, of course, affects the company interest as the guideline for the company's business. The company is no longer directed only towards its own interest, but the interest of the group comes into consideration. The very purpose of the formation of the group is to combine the resources of the group members so that the best for the group as a whole is achieved. The pure interest of the company can no longer be isolated; on becoming a member of the group, the company interest is aligned to that of the group, and both company and group interest are blended.³⁸⁵ In exceptional cases even direct conflicts between the group and the company interest may arise. In particular, the interest of the group is directed to a maximization of overall group profits, although this may not always be

³⁸⁴ cf. already Mestmäcker (1958), *supra* note 43, p. 119ff.

³⁸⁵ cf. for the transformation of the company interest in a group Druey (1980), *supra* note 14, p. 305-308; Mestmäcker (1958), *supra* note 43, p. 278-280.

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synonymous with maximizing profits for the single affiliated company.³⁸⁶ In these situations, the interest of the parent and the interests of the creditors are not identical, and the dominant enterprise may use its influence on the management of the subsidiary to receive special advantages to the damage of the creditors. Through the economic links between the group members, the unified management of the parent may be able to shift profits and assets between the companies, e.g. by the setting of transfer prices, the granting of credits, or by the attribution of new fields of business. Such conduct may endanger the position of the creditors of the affiliated company.

These considerations cannot be transferred to the company form of a *GmbH* without changes. The shareholders are much stronger in the framework of the *GmbH*, as the directors are not independent and the shareholder assembly can issue (legally binding) instructions on them in all fields of the company's business activity. As can already be seen for the difficulty to transfer shares of a *GmbH* (*GmbHG* § 15 (3), (5)), the *GmbH* has from the very beginning been conceived as a company with few and permanent shareholders, who normally form part of a confidential relationship, and want to stay in control of the company and have a comprehensive influence on its business decisions. In contrast to the *AG*, the concept of the *GmbH* makes it possible by legal means for one (or several) shareholder(s) to determine the business activity of the company comprehensively. Limits are set on the shareholders by imposing fiduciary duties which make use of the company interest as a substantial criterion on them. However, as described above, fiduciary duties are not an effective means for protecting creditors because they primarily protect minority shareholders and only as a reflex of this do they protect the interests of the creditors.³⁸⁷ The company interest of a *GmbH* does not counterbalance the domination of the company as it still forms a guideline for the company's management³⁸⁸, but can be largely determined by the shareholders. The domination by one (or several) shareholders is therefore inherent in the legal structure of the *GmbH*, the *GmbH* providing thereby an instrument for the shareholders to run their business in the form of a company. Beside this normal domination by their

³⁸⁶ Very strongly focussing on this point Antunes (1991), supra note 19, p. 132-134.

³⁸⁷ See above C III 1.

³⁸⁸ See for the company interest as a guideline for the *GmbH*'s directors *GmbHG* § 47.

shareholders, for a *GmbH* in a group the particular point is that the parent pursues other entrepreneurial interests and may have more opportunity to shift the profits and assets of the company by normal business transactions, whereas a dominating private shareholder can only pursue special, private interests.

The question is what the consequences of the different structure of the *GmbH* in comparison to that of the *AG* for the protection of creditors in a group are. On the one hand, it could be argued that the creditors have to be especially protected because of the shortcomings of the *GmbH* structure. It could derive from this that, as the defects of the liability rules in the *GmbH* have to be balanced in any case, it could be started to do so with a special group liability for groups with an affiliated *GmbH*. On the other hand, it seems preferable to argue that for a normal use of a *GmbH*, which includes a far-reaching domination of the company by its shareholder(s), the statutorily provided legal means for the protection of the creditors have to be sufficient, and no further means have to be developed. To put it in other words, the level of the creditor protection cannot be increased to that of the *AG* by a special group liability in order to compensate for a weakness of the creditor protection which is already inherent in the *GmbH* form. Therefore, the parent company cannot be prevented from or punished for directing an affiliated *GmbH* within the limits which are established for a private shareholder. However, a special liability for the parent is to establish if it is necessary to cope with the additional risk caused by a group, that is the possible mix up with the entrepreneurial interests of other group members and the possibilities of influencing the profits and assets of the affiliated *GmbH* by using the economic links between the group members. In order to assess the risk it is also necessary to examine the shortcomings inherent in the structure of the *GmbH*; this should establish to what degree the protection of the creditors in the structure of the *GmbH* is insufficient regarding the additional risks caused by the group structure.

The group also affects the authority structure of the affiliated company. Particularly in the *AG*, the definition and distribution of powers between the company organs are distorted because in the group the directors of the affiliated company are the organ which carries out the group policy, determined by the parent directors, whereas

the supervisory board and the general assembly of the subsidiary are exposed to the domination of the parent enterprise. However, this problem seems to be less severe in the *GmbH* since -as shown above- the structure of the *GmbH* makes a far-reaching domination of the company by the shareholder assembly possible in any case, and the checks and balances between the organs in the *GmbH* are not very prominent. Furthermore, this problem may not be very relevant for the protection of the creditors. A shift of the organisational competences horizontally between the different organs and vertically to the unified management of the parent would in principle not affect the position of the creditors if not the above-shown transformation of the subsidiary's interest were correlated.³⁸⁹ This is why the criterion of the substantial and permanent performance of management for the qualified de facto group has been pushed into the background behind the interest criterion. A further reason for this can be found in the above-described structure of the *GmbH*, which already normally provides the legal means for the domination of a company by the shareholders.

However, to maintain the organisational structure of the *GmbH* may also be important for the creditors to a certain extent. The affiliated company is, even when in a group, able to pursue a certain self-interest, even though the group interest influences the company interest. However, if the parent has completely instrumentalized the subsidiary -i.e. the unified management is very far-reaching and the parent has taken over the management of the subsidiary in detail- the subsidiary can no longer be seen as a separate body able to pursue its own interest. Without giving the subsidiary management some autonomy, the organisational separateness of the company is abolished and the subsidiary is exposed completely to the interest of the parent, and the organisational structure necessary to build up a self-interest in the economic well-being is eliminated. As this self-interest of the company would also serve the interests of the creditors, a total abolishing of the organisational structure of the subsidiary per se would impair the interests of the creditors.

³⁸⁹ cf. also Immenga (1985), supra note 160, note 3.

b. Direct Protection of Creditors by Provisions for the Maintenance of Capital

The most important direct instrument for the protection of the creditors in the company is the separate capital fund of the company, which finds its statutory expression and guarantee in the principles for the formation and maintenance of the equity capital. These provisions form the basis for the separation of the company assets and are the necessary correlation to the limited liability of the shareholders.³⁹⁰ However, the principle of the maintenance of capital in principle may be structurally endangered by the group, that is the statutory provisions may be insufficient to cope with the dangers caused by the group for the equity of the affiliated company, since this principle -like the whole company structure- is aligned to the activity of an independent company.

The link between a special group liability and the insufficiency of the provisions concerning the guarantee capital -or, in the language of the *AktG*, the link between the obligation to balance the losses and these provision- is contested by the argument that the provisions concerning the equity capital do not deal with the making good of losses. According to this opinion, the special group liability serves only to compensate for additional creditor risks which emerge from the lack of attention being paid to the principle of an organisational separation of the company.³⁹¹ This opinion fails to take notice of the correlation between the organisational separateness of the company and its separate patrimony. The direct task of protecting creditors is taken over by the provisions securing the separate assets of the company for the creditors, and this separate organisation finds its expression in this field in the separate company patrimony. The patrimonial order of the company cannot strictly be separated from the organisational order. The company as an organisation employs the assets of the company for entrepreneurial purposes, whereby the equity capital of the company is not frozen as a last security of the creditors but forms the patrimonial basis to finance the business activity of the company. The organisational order of the company, the way in which the business is run, the checks and balances which exist between the company organs, and, above all, whose interest is pursued by the company doing business has an

³⁹⁰ Mestmäcker (1958), supra note 43, p. 326.

³⁹¹ K. Schmidt (1992), supra note 338, p. 116.

impact on the use of the company's assets and its equity. The creditors of the company are therefore first and foremost protected by a successful business of the company and only in second place by the guarantee capital. Thus, it is not possible to focus only on the provisions concerning the capital by coping with the dangers arising from the group form³⁹², since these provisions have to be regarded with respect to the transformations caused by the group organisation. Nonetheless, the problem of creditor protection cannot be reduced to a general discussion about the organisational order of the company, as the concept of company law links directly the protection of the creditors with the company's separate fund and the provisions about formation and maintenance of equity. Therefore, the provisions concerning the equity have to be seen in the framework of the concept of the company as a separate body with its own organisation and it needs to be analysed whether the provisions concerning the separate fund in this framework are insufficient to cope with the dangers caused by the group structure. If the protection of the creditors is undermined, a liability of the parent in whatever form has to be taken into consideration as a substitution for this concept - even if the provisions concerning the equity do not deal with the making good of losses of an extension of liability.

The separate fund is provided by the formation of a certain equity capital. This must be at least 50.000.- DM for the *GmbH* (*GmbHG* § 5) and is entered into the Commercial Register so that creditors can assess the credit-worthiness of the company in this point. It is sometimes stated that in groups the member companies are often undercapitalized³⁹³, that is the equity capital is inadequate for the concrete business of the company. However, this does not seem to be a structural problem of the group itself; it is very often reported that newly founded, independent *GmbHs* are inadequately equipped and have only the minimum capital of 50.000.- DM so that the risk of a breakdown in the first economic crisis is fairly high. The difficulty in this respect seems to be how to develop a formula to determine an adequate capital structure for the

³⁹² Tending to such a view see Ulmer (1986), *supra* note 372, p. 126; id., "Gläubigerschutz im 'qualifizierten' faktischen GmbH-Konzern", *Neue Juristische Wochenschrift* 1986, p. 1583f.; following him in wide parts the *BGH* in BGHZ 107, 7, 18 - Tiefbau.

³⁹³ See Antunes (1991), *supra* note 19, p. 110f.

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business in hand. This problem appears to be similar for both companies which form members of a group and independent ones³⁹⁴; it will therefore not be examined any further.

The relevant provisions for the maintenance of capital in the *GmbH* can be found in *GmbHG* §§ 30, 31. These provisions only protect the nominal capital against being paid-off to the shareholders - in any form whatsoever. Reserves of the company can be distributed if the nominal capital is not affected. In comparison to the *AG*, the principle of the maintenance of capital in the *GmbH* is less strict; in the *AG*, all the assets of the company are secured against a distribution to the shareholders (*AktG* §§ 57 (1), 58 (5), 62), and only profits as they are shown in the balance sheet may be distributed. Reserves can only be distributed if they are dissolved in profits (if they are not secured against distribution as statutory reserves or in another form). In both companies, shareholders cannot claim the distribution of dividends if losses are not made good by profits so that the nominal capital is not touched by the distribution (*GmbHG* § 29). Thus, the creditors can trust in a separate fund of the *GmbH* only in so far as it is provided by the nominal capital, whereas assets over and above this are not guaranteed by the provisions regarding the maintenance of capital. The nominal capital is secured against unlawful distribution in whatever form this may happen. A distribution of company assets includes every patrimonial advantage which serves the direct or indirect benefit of the shareholder and comes from the assets of the company and does not comply with provisions for the maintenance of capital; the advantage must be passed on to the shareholder because of his status as a shareholder.³⁹⁵ Legal transactions violating the provisions for the maintenance of capital are invalid³⁹⁶; received payments by a shareholder are to be paid back to the company (*GmbHG* § 31).

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The group structure calls into question the efficacy of these provisions for the

³⁹⁴ A group specific problem may be posed by the fact that the financing of the subsidiary company is embedded in a global financial strategy of the group, see Schneider (1984), *supra* note 205, p. 497-506; Antunes *ibid.*, p. 111, but this does not seem to touch upon the function which the formation of the equity capital has in the individual subsidiary.

³⁹⁵ See Wiedemann (1980), *supra* note 13, p. 440-443.

³⁹⁶ Wiedemann, *ibid.*, p. 442.

maintenance of equity capital. These provisions are equally directed against abuses of the company's assets by a private shareholder or by a group. In the case of a private shareholder, they are to prevent abuses by shifting company assets into the private wealth of the controlling shareholder; typical cases are the granting of credits, the paying of pensions or salaries without any obligation to do so, or the selling of property belonging to the company for a low price.³⁹⁷ The situation in a group may differ slightly. In a group, a normally wide spectrum of financial and other business linkages exists - between parent and subsidiaries and the subsidiaries themselves. Even in conglomerate groups at least a uniform financial management is normally performed. Using the economic links between the group members, the group management finds various opportunities for shifting profits as well as assets between the companies. In this respect very critical transfer prices are seen, but other contingencies also exist for the group in order to take over assets from a subsidiary, by transferring patents, real estate, and know-how to other group members, by entering into contracts with inadequate conditions for the subsidiary, or by attributing business opportunities to other group members.³⁹⁸ In performing such business, the parent may abuse the unified management by harming the subsidiary, or, to put in the language of abuse, the parent may influence the subsidiary through dark channels leading to self-damaging behaviour by the subsidiary to the benefit of the parent.³⁹⁹

The structural effects of the group may be more important in this respect. The uniform management establishes financial and business links between the group members for entrepreneurial purposes, so that the group forms an economic unity and benefits from the advantages which can be achieved by internal coordination between the member companies and not from coordination via the market. The treatment of the group as an economic unity may render it difficult to identify the results and the assets of the single companies.⁴⁰⁰ In an independent company the market draws a sharp

³⁹⁷ See Wiedemann, *ibid.*, p. 438ff.

³⁹⁸ See for a list of critical regarded transactions in a group Emmerich/Sonnenschein (1993), *supra* note 186, p. 22f.; and the careful analysis by Mestmäcker (1958), *supra* note 43, p. 302-316, 325-336.

³⁹⁹ In such statements of the legal literature the suspicion which the group often is subject of becomes obvious, see e.g. Emmerich/Sonnenschein *ibid.*

⁴⁰⁰ See for a very thorough analysis of this field Mestmäcker (1958), *supra* note 43, p. 303-316; however, he deals with a rather hierarchical group organisation, predominant at that time.

distinction between the company and its business partners, thus the assets of the company -more precisely the separate fund of the *GmbH* as this is defined by law- are open to market transactions, whereas they are closed to the shareholders - apart from the distribution of profits. In connection with the economic self-interest of the company, it is assumed that a guarantee of correctness lies in the market transactions so that creditors of the company have only to bear the normal risk of business failure in a market economy. Private shareholders perform business transactions with the company only in exceptional cases, the provision about the maintenance of capital help against abuses by private shareholders. In a group business transactions are often performed between group members; these transactions are no longer exclusively directed by the market, but the allocation of resources is at least partly performed by internal direction. It may be rather difficult to transform the effects of internal direction into prices which are normally formed freely in the market and to separate the group effects from the results of the single companies so that profits and assets of the economic unity group can be correctly divided among the individual group members. Internal direction of the resources cannot be assumed to have the same guarantee of correctness as market transactions. In a group the patrimonial structure of the subsidiary no longer seems to be so closed towards the shareholder/parent, but via the group management the parent can use the assets of the company without the sharp distinction of the market between them. Thus, the function of the separate fund of the company and of the provisions about the maintenance of capital is affected, as profits and assets can only be precisely determined in relation to the market, not with regard to other coordinative instruments. In addition, the exact distribution of the assets and profits of the group to the individual companies might not be so important from the point of view of the group management since the group management -viewing the group as an economic unity- aims above all at maximizing profits and assets in the interest of the group as a whole, and may even shift profits and assets via the economic links between the companies wherever it is most useful for the group as a whole without taking into account the interest of the individual member companies.⁴⁰¹ As a consequence of the structural deficits of the provisions about the maintenance of capital, these provisions are declared invalid in a

⁴⁰¹ For the whole complex see Antunes (1991), supra note 19, p. 107-114.

group based on contract (*AktG* § 291 (3)).⁴⁰²

To sum up, the danger for the separate fund of the *GmbH* and the provisions concerning the maintenance of capital comes from the economic unity of the group which leads to a substitution of the pure market relationship between the companies is substituted by an internal management relationship. This is why it is difficult to assess the transactions between the companies precisely in market terms and to control their compliance with the provisions about the maintenance of capital and the separate fund of the company. Nevertheless, it remains to analyse how these dangers are realized to the damage of the creditors in the organisational structure of the group under discussion - in comparison to the risk they run in a typically independent *GmbH*.

c. Compatibility of the Organisational Structure with the Legal Requirements of Limited Liability

The nature of the group was described above as an organisation standing between the market and hierarchy, an organisation able to combine both these characteristics and to oscillate between the two points according to its actual needs. The subsidiaries pursue their own interest in the market to maximize their profits, while their autonomy is limited by hierarchical interferences of the group management in the framework of the strategic direction. These characteristics of the economic organisation have to be borne in mind when it is asked whether the organisational structure produces additional risks for the creditors leading to a lack of compatibility with the legal requirements of limited liability. Additional risks for the creditors may result from a transformation of the company interest in a group, from a radical change in the authority structure of the affiliated company, and from submitting the company to a hierarchical organisation so that it is no longer aligned only to the market.

⁴⁰² For an unfair seeming result of this see the judgement OLG Düsseldorf, *Die Aktiengesellschaft* 1990, p. 490ff.; whether this is also valid for the affiliation of a *GmbH* by a contract does not seem to be quite clear; see the negative statement in this respect by Emmerich, in Scholz, *GmbH-Gesetz* (1993), 8th ed., Vol. 1, annex "Konzernrecht", note 277.

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The company interest of a *GmbH* in a group structured in this way seems to be compatible with the interests of the creditors. The subsidiary company as a profit centre is still aligned to the profit maximization principle, and it keeps a self-interest to make profits in the market. Only in this way can the subsidiary contribute to the goal of the group as a whole, that of maximizing overall profits. The subsidiary pursues this interest only in the framework which is set by the strategic group management and given by the entrepreneurial interest of the group. However, such a strategic determination of the subsidiary does not seem to be very different from the determination of a *GmbH* by its private shareholders, the legal means for which are provided in the right of the shareholder assembly to issue instructions.⁴⁰³ The interest of the group therefore does not prevent the single subsidiary from pursuing the goal of maximizing profits for itself, but subsidiaries are established as subunits in order to transfer the profit maximization principle to a lower level, so that already the subunits are aligned to the dominant goal of every economic unit. Thus, in this structure, while the interest of the *GmbH* seems to be parallel to the interests of the creditors, and in general there seems to be no reason for the creditors placing more confidence in a parallelism of their interest with an "independent" *GmbH*, dominated by a private shareholder, than in the parallelism with a subsidiary having a rather autonomous profit centre standing.

The organisation of a *GmbH* as a subsidiary seems to be compatible with the requirements for the protection of creditors. In a group organised in this way the subsidiaries are integrated into a systematic group management, and they are included in the strategic long-term planning and control of the group. In this respect, the organisational order of the company is changed. However, it was shown above that a mere distortion of the organisational order does not affect the interests of the creditors in any particular way if there is no resulting change in the company interest. The limit for an organisational change which also affects the position of the creditors was defined above as the point at which the parent takes over the management of the subsidiary in

⁴⁰³ See for inhowfar to maintain a legally defined company interest is useful for the economic structure B III 3 a. See for the general compatibility of the interest of a profit centre in the economic structure with the company interest in the *GmbH* C III 2.

detail, that is when the parent completely instrumentalizes the company form.⁴⁰⁴ In this case, the *GmbH* is not kept as a separate body at all, the principle of organisational separateness of the company is violated, and the *GmbH* is no longer able to develop a self-interest. In a group organised as described above the *GmbH* as a subsidiary is directed in part by the group management, but it maintains its own organisation, which is responsible for the company. One reason for establishing profit centres is the desire to attribute responsibilities and competences in a clear-cut way and to give the management of the subunits the autonomy it needs to exercise its competences. Otherwise, the main goal of such a structure, to be able to clearly attribute success or failure to the management of the subsidiary, could not be achieved. Therefore this structure establishes its own organisation which is to develop the profit principle of the subsidiary -as stated above- in the framework of the group interest. There seem to be no reasons why such an organisational structure should affect per se the position of the creditors.

However, the above-used criterion of the *BGH* for delimiting the qualified de facto group, that is the performance of comprehensive and permanent management by the dominant enterprise, could suit a group organised in this way. The group management in this structure is exercised in a permanent way, as otherwise the group is no longer in control of the subsidiary and cannot bear the risk. It is questionable whether the criterion of comprehensive management is fulfilled if the group management limits itself to strategic management decisions. However, as the *BGH* in the *Tiefbau*-case already considers the exercise of comprehensive financial management sufficient for this criterion and as -in general- a subsidiary can be comprehensively directed and controlled by performing strategic management, a so-structured group would be to assess as a qualified de facto group according to the *BGH*. Therefore, this criterion in the interpretation of the *BGH* does not seem to be suitable for drawing a line beyond which an extension of liability on the parent can be established.

The economic organisation provides an incentive for maintaining the function of

⁴⁰⁴ cf. the description by Lutter (1990), supra note 341, p. 184, "if the management of the subsidiary is gone over to the parent company in the core".

the separate fund of the *GmbH* and the provisions regarding the maintenance of capital. In a group, the market principle is substituted for internal direction in the area of strategic management and partly for the internal exchange of goods between the group members in order to achieve the advantages of close cooperation. Any influence in the strategic respect does not seem to affect the working of the separate fund, the results, and the assets of the company very much; more problematic are the financial and business links between the companies. The exchange of goods can be influenced by the group management, but the organisation with autonomous subunits having a profit centre standing only works if the units are as much as possible exposed to the market and if, within the group organisation, the market principle is dominant. A deviation from the market principle results in an unclear and confused structure and makes a clear-cut attribution of competences and responsibilities impossible. Hence, there is an organisational incentive largely to establish the market principle for the relations between the companies, and to distribute the results of the group as a whole to the group members according to their individual results.⁴⁰⁵ The economic incentive to maintain the legal structure is intensified as such an organisation seems to be the only feasible one for an enterprise with multiple products and business fields in several markets.⁴⁰⁶

The separation on capital which is invested in the company has a function in the economic structure also. The most decisive factor for strategic management is to determine the yield of the subsidiary which is fixed in relation to the invested capital - it is therefore also called the return on investment (ROI). For this, the invested capital which is employed for entrepreneurial purposes in the company has to be determined precisely; as a result already organisational reasons reject an uncontrollable shift of assets and profits. Thus, the laying-down of the invested capital in the organisational structure fulfils the same function as the separate fund in the legal structure of the

⁴⁰⁵ Arguing for an incentive of the group to keep a profit centre structure Posner, "The Rights of Creditors of Affiliated Corporations", 43 *University of Chicago Law Review* (1976), p. 511f.

⁴⁰⁶ cf. Mestmäcker (1958), *supra* note 43, p. 308f., who already considered such a structure but did not deal with it in detail as he could not imagine that a group would introduce such a structure only in order to perform a correct account. To make such efforts only for a correct account in a group really seems to be improbable, but to introduce and keep such a structure for necessary organisational reasons seems to be plausible.

may also have positive effects for the creditors: in order not to reduce the credit worthiness of the other subsidiaries and the group as a whole, the group may support (because of such market forces) a subsidiary in difficulty.

In general, such an organisation of the group seems to be compatible with the concept of the protection of creditors provided for by company law; however, what is more doubtful is the compatibility of the single measures of the group management with the interests of the creditors. A highly centralized financial management in the group may especially affect the position of the subsidiary's creditors as it may completely distort the result of the individual subsidiary and leave no room at all for autonomous decisions, as well as the concrete determination of transfer prices within the group, in general a mixture of the assets of the different companies, and so on. The limits of these management instruments are shown above with regard to the keeping of the company structure. An exceeding of the structure assessed on the concept of company law with regard to the creditors justifies an extension of the liability on the parent; in this case, the dangers arising from the group structure for the protection of the creditors are apparent. However, the legal concept of the company with regard to the creditors does not make a special group liability which is simply tied to the performance of unified management by the parent necessary.

d. Compatibility of the Criteria for the Qualified De Facto Group with the Findings

The criteria for delimiting the qualified de facto group must be assessed according to the legal rationale found for a special group liability and its application to the economic organisational structure of the group. Two main criteria have been described, on the one hand the comprehensive and permanent management of the parent and, on the other, the lack of attention paid to the subsidiary company's interest.

The criterion which focuses on the notion of a comprehensive and permanent management has already been rejected above as suitable since it seems to be nearly impossible to delimit this in regard to the unified management, which -as the

GmbH and the provisions about the maintenance of capital: they attribute a fixed capital to the unit in order to enable it to pursue entrepreneurial success which is assessed by the result of the invested capital in the market.

In comparison to an independent *GmbH* in a typical use the situation of a *GmbH* as a subsidiary in a group structured in this way does not seem to be structurally worse for the creditors.⁴⁰⁷ Because of the company structure, the creditors can only have confidence in the availability of the guarantee capital as it is entered in the Commercial Register; assets which exceed the nominal capital can be redistributed to the shareholders. In a *GmbH* with private shareholders such a distribution may occur for private expenses in particular. In a *GmbH* as a subsidiary, organised according to the structure described, the creditors can have confidence in the attribution of a fixed capital to the subsidiary and that it will not be withdrawn afterwards, as the group will want to pursue entrepreneurial purposes with it and to keep the organisational structure working. In the same way, the creditors can trust the company to pursue a profit maximization goal. The mere equity capital, in whose existence the creditors can only trust in the *GmbH*, does not offer protection for the creditors on a high level. Normally, the main security of the creditors does not consist of the legally defined separate fund, but is given by the general profitability of the company, by the self-interest of the company to continue performing business and staying in the market, and by the reputation of the company in the market. Weaker influences of internal direction on the transactions which are in principle performed according to the market principle between the companies may affect the provisions about the maintenance of capital but do not affect the position of the creditors to any great extent if the working of the legal provisions is embedded in other factors protecting the creditors. And, in principle, the group structure offers strong incentives to provide for a strict separation of the capital and a correct distribution of the profits among the subsidiaries so that the legal provisions will be complied with. As one other factor, the economic unity of the group

⁴⁰⁷ Going further and denying a serious need for a specific protection of creditors in a *GmbH* group as the bankruptcy statistics especially shows the winding up of independent *GmbHs* Zöllner, in Baumbach/Hueck, *GmbH-Gesetz* (1988), 15th ed., annex I "Konzernrecht", note 25; Kübler (1991), supra note 352, p. 422.

constituent of the group- already is very difficult to define.⁴⁰⁸ Furthermore, a decentralized group structure also falls in with this criterion, although the legal rationale of a special group liability does not require it to be introduced for such a structure. This criterion -with regard to the *GmbH*- does not focus on the point at which the legal precautions for a protection of the creditors become insufficient and the additional dangers arising from the group structure in comparison to an independent *GmbH* become apparent. Only if the management of the subsidiary is to a very wide extent performed by the parent will such a shift of the management per se endanger the position of the creditors, and may also trigger off an extension of liability on the parent.

A more suitable criterion can be found in the second, which deals with the ignoring of the interest of the subsidiary by the parent. It would appear to be too abstract to be applied directly, therefore the way in which the interest of the subsidiary has to be ignored for an extension of liability on the parent must be established. The insufficiencies of the legal concept for the creditors -these form the basis of the need for a special group liability- require a delimitation for a special group liability along the lines whether the company as an organisational unit is still primarily aligned to the market or whether it is only a bodiless instrument for pursuing the (market) interests of the parent.⁴⁰⁹ If the subsidiary is still aligned to its market and employs its capital for maximizing profits for itself in the market, it cannot be said that the interests of the subsidiary are completely ignored even if the entrepreneurial direction of the *GmbH* is taken over by the group management in strategic respects. The qualified de facto group can therefore be delimited by the test indicating whether the affiliated *GmbH* still exists as a subject in the market or whether the alignment of the company to the market is largely distorted by internal direction so that profits (or losses) and assets of the company are only the result of an arbitrary distribution within the group performed by the group management. For a concretization of this test the above-described criteria can be referred to in order to see the way in which a profit centre should be established and

⁴⁰⁸ See above A.

⁴⁰⁹ cf. also the criteria by Landers (1975), supra note 381, p. 621-623, for determining whether the company is operated as a viable business.

managed.⁴¹⁰ A deviation from the model of a group organisation in which the subsidiaries are treated along the market principle would lead to an extension of liability on the parent, single measures in this respect could already indicate a non-compliance with such a structure and would trigger off a liability of the parent.

This criterion in the above-proposed interpretation can be applied to the cases of the *BGH*. The arbitrary shift of the movable cranes between the companies, the devouring of all the profits of each subsidiary by the factoring company of the group, and the lack of autonomy of the directors of the individual companies⁴¹¹ in the *Autokran*-case are more than sufficient for extending liability on the parent, as the companies are by no means aligned separately to the market; however, a confused situation is produced in the group in that the companies can no longer be viewed as separate. The simple uniform financial management would not suffice for the application of a group liability, as expressed in the *Tiefbau* case, although there are indications for an instrumentalization of the company in order to cover up the debts of the parent and other shareholders;⁴¹² these facts could justify a group liability as then the company would no longer be seen as a self-sustaining actor in the market. In the *Video* case, remarks about a mixture of assets between the different group members⁴¹³ could have justified the extension of liability; however, the justification given by the *BGH*, an extension of liability because of the comprehensive and permanent management of the only shareholder and director of the company, cannot be accepted, as shown above. In the *TBB* case, the decision of the *BGH* can be supported since a uniform cash management performed by the bank for the whole group does not per se trigger off a special group liability; however, a group liability is justified if this instrument -and the underlying credits to other companies of the group- leads to any danger for the activity of the *GmbH* in hand.⁴¹⁴ In this case, the subsidiary is no longer seen as a separate actor in the market, and an economic unity of the group in

⁴¹⁰ See B II 1 b.

⁴¹¹ BGHZ 95, 330, 336f., 338f.

⁴¹² See the facts of the *Tiefbau*-case and the considerations of the *BGH* with regard to *GmbHG* § 30, 31 BGHZ 107, 7-15.

⁴¹³ See BGHZ 115, 187, 192.

⁴¹⁴ BGH *Juristenzeitung* 1993, p. 578 - TBB.

this form would lead to a complete ignoring of the company with its separate assets, interest, and body.

e. French Law

This conclusion is supported by French jurisdiction with regard to groups. French criminal law penalizes an abuse of the company's assets by the company's directors; the criterion for abuse is the *intérêt social*.⁴¹⁵ The *Chambre Criminelle* of the *Cour de Cassation* has developed a ground of justification in this field especially for groups; according to this financial assistance by one company to another in a group is not seen as an abuse of the company's assets under the following conditions.⁴¹⁶ First, the companies must form a group which the *Cour de Cassation* avoids defining more precisely; according to other judgements of lower courts, there must be a strongly structured economic and financial unity⁴¹⁷ - this may be translated by a uniform management. According to the *Cour de Cassation*, the financial transactions have to be necessitated by a common economic, social, or financial interest which is assessed with regard to a systematic policy for the group as a whole. Second, the financial help must be balanced and may not destroy the equilibrium between the activities of each of the companies concerned. Third, the financial aids may not exceed the financial possibilities of the company which is charged with these transactions. These conditions have to be given cumulative in order to justify financial assistance within groups. The *Chambre Commerciale* has not yet confirmed this jurisdiction, but among scholars the opinion is predominant that it can be transposed into civil law.⁴¹⁸ On this ground of justification, not only the civil liability of the directors can be excluded, but also all the other

⁴¹⁵ According to *Loi 1966* Art. 437-3 for the S.A. and Art. 425-4 for the S.A.R.L.

⁴¹⁶ *Cour de Cassation (Chambre Criminelle)*, judgement from 4 February 1985, *Revue des Sociétés* 103 (1985), p. 648ff., especially p. 651 - Rozenblum, with note by Boulloc; confirmed by judgement from 13 February 1989, *Revue des Sociétés* 107 (1989), p. 692ff. - Duval, with note by Boulloc; further references by Pariente, "Les groupes de sociétés et la responsabilité pénale des personnes morales", *Revue des Sociétés* 111 (1993), p. 249f.

⁴¹⁷ Especially the decisions of the *Tribunal correctionnel de Paris*, judgement from 16 May 1974, *Recueil Dalloz Sirey* 1975, *jurisprudence*, p. 37 - Willot; and of the *Tribunal de Grande Instance de Mulhouse*, judgement from 25 March 1983, *Recueil Dalloz Sirey* 1984, *jurisprudence*, p. 285ff. - Schlumpf, with note by Ducouloux-Favard; see also the references by Boulloc, "Droit Pénal et Groupes d'Entreprises", *Revue des Sociétés* 106 (1988), p. 188.

⁴¹⁸ See Guyon (1993), *supra* note 9, p. 149.

provisions which establish the parent's liability by focusing on the company interest. Whether by compliance with these criteria all other possibilities for assuming liability of the parent are excluded does not seem to be clear.⁴¹⁹

Contrary to the above-shown criteria for the qualified de facto group in German law, two points in particular need to be mentioned. First, the performance of unified management according to a systematic group policy is not seen as critical in French law but is one of the conditions for privileging the group in this respect. Thereby, the rejection of the criterion which ties the extension of liability only on the comprehensive and permanent management is supported. Second, the qualifications of the subsidiary's treatment for privileging the group are remarkable. The interest of the company is redefined: it is not defined either as that of an independent company or quasi completely put at the disposal of the shareholders/the parent; instead a company interest within the group is defined. The company can claim adequate consideration within the framework of a coherent group policy, its assets are still protected as the financial transactions in the group should not endanger the existence of the company and there must be an equilibrium regarding these transactions. The company interest is therefore shaped by the group interest, but a self-interest of the company is upheld as the company forms a separate body in the framework of a systematic group policy. This is lined up with the well-being of all group members and as the patrimony of the company remains separate from the other group members, it is protected against any damage which is not balanced within the systematic group policy. An interest of this type remains the guideline of a company which is seen as the member of a group but at the same time as a separate body with its own self-interest. Such a view of the company in a group seems to be comparable to the profit centre standing of a company. The strategic management performs a systematic and coherent group policy, whereas the companies maintain their self-interest by making profits in the market. The parent is not allowed to exceed the limits beyond which the subsidiary as a separate body with a

⁴¹⁹ Especially relevant in this field are the *action en comblement du passif* and the *extension du redressement judiciaire* according to *Loi n 85-98 du 4 janvier* Art. 180, 182; see for excluding the liability the rather cautious statements by Lutter, "Zur Privilegierung einheitlicher Leitung im französischen (Konzern-) Recht", *Festschrift für Kellermann* (1991), p. 265f.

$$\begin{array}{c} \frac{\partial}{\partial t} \\ \vdots \\ \frac{\partial}{\partial x_1} \end{array}$$

separate patrimony and its own self-interest would be affected. In such an interpretation the ground for justification generally defines the limits of a unified management in the group and does not only draw a line beyond which an abuse of company assets takes place.

f. Categorizing the Concept

The above-described concept for an extension of liability on the parent has to be inserted into the already-mentioned categories of liability owing to the installation of an organisational structure or of liability for the conduct of the subsidiary's business by the parent in an abusive way. With the above, an organisational form is presented which excludes the extension of liability, and accordingly the extension of liability is tied on an organisational structure which exceeds the limits of the concept above (e.g. a very centralized group). However, the limits of the organisational structure are exceeded by single management measures, such as fixing transfer prices at an inadequate level, causing a mix up of the assets of the different companies, installing a financial management which does not leave the subsidiary any autonomy at all, or, in general, determining the management of the subsidiary in detail. Therefore, one could say that the extension of liability is connected with an organisational structure which is achieved through the behaviour of the group management.⁴²⁰ An extension of liability which refers only to an organisational status seems necessarily to have to choose the unified management as a starting point; this can be seen as indicating the point at which the general transformation of the organisational status of the company takes place.⁴²¹ All further organisational concepts with which a liability of the parent could be connected result from further-reaching interferences on the part of the group management. There does not seem to be a way within the spectrum of unified management to define a group organisation which does not take single management measures of the group management into consideration. Thereby the proposed concept provides for an extension

⁴²⁰ Considerations in this direction already by Stodolkowitz (1992), *supra* note 364, p. 1519; Westermann (1993), *supra* note 366, p. 556f.

⁴²¹ See e.g. the very thorough analysis by Assmann (1992), *supra* note 244, p. 718-726, who shows that exceptions from the extension of liability do not fit into the concept of liability for an organisational status.

of liability if the limits of the described organisation are exceeded by any interferences of the group management.

3. Economic Rationale for a Group Liability

The limited liability of a company is a way of distributing the risk between the shareholders and creditors of a company: the liability of the shareholders is limited to the assets of the company, and it is the creditors who bear the risk of the company's winding-up at the end.⁴²² The risk-sharing is not a one-sided legal privilege for the shareholders, who externalize the risk of the company's economic activity on the creditors, but the limitation of shareholders' liability can be justified with regard to the appropriateness for the relation between the different interest groups. The holding of shares is promoted by a structure in which the shareholders can only loose the money they have invested into the company. The creditors, on the other hand, normally consciously assume the risk of the bankruptcy of the company as they know about the feature of limited liability of their market partner. The creditors assess the risk and demand compensation for their risk-bearing in form of a higher interest rate, while the debtor obtains the desired limitation of his liability. The risk is therefore internalised into the contract by market mechanisms, and there is no externalisation as creditors are compensated for assuming the risk arising from the limited liability.⁴²³

Nonetheless, the limitation of the shareholders' liability is simply the standard distribution of risk: as in the case of unlimited liability the parties of a contract can agree on a contractual limitation of one party's liability, and the company's limited liability can be extended to the shareholders with their agreement. Market forces can therefore cause a change in the company's standard liability order by the shareholders' taking over guarantees for the debts of the company. If, therefore, the distribution of risks according to limited liability does not fit the interests of the different groups in the

⁴²² See in general Posner (1992), supra note 28, p. 395f.; Woodward (1985), supra note 334, p. 601; Kübler (1991), supra note 352, p. 404; Roth, " 'economic analysis' der beschränkten Haftung", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 15 (1986), p. 374;

⁴²³ Fundamental Posner (1976), supra note 405, p. 502-507; Easterbrook/Fischel, "Limited Liability and the Corporation", 52 *University of Chicago Law Review* (1985), p. 104-107; Roth. *ibid.*

market, the parties can contract around liability. In this case, the interest rate demanded by the creditors is lower as it does not include a surcharge for additional risk-bearing. Who it is, in a concrete situation, that takes over the risk for the winding-up of the company depends on who the cheapest risk bearer is; thereby, an efficient solution is achieved by market mechanisms. The function of company law in this respect is seen as providing a set of standard, implied contract terms so that business firms do not have to stipulate these terms anew every time they transact, even if they can re-negotiate the terms if necessary. The function of the law therefore lies in economising on transaction costs.⁴²⁴ Limited liability is chosen as the standard solution for a company as creditors are often seen as those who are the superior risk-bearers⁴²⁵, therefore the limitation of liability for the shareholders is normally the efficient solution and would also emerge in contractual arrangements directed by market mechanisms.⁴²⁶

The limited liability in a company cannot only be extended by the will of the contracting parties, but the distribution of risks can be changed by the court's ordering a piercing of the corporate veil and an extension of liability on the shareholders. By installing a special liability in the group, the courts can provide for a legal remedy if the market is not able to bring about an efficient overall solution for liability and distribution of risk. If efficiency considerations prefer a general liability of the parent for the subsidiary's debts in a group, the legislator should introduce this as a standard liability model since such an efficient standard solution helps to economise on transaction costs.

According to these considerations, it needs to be analysed whether efficiency considerations and the economic rationale for limited liability accommodate the legal criterion according to which liability is only extended in certain groups and the above described structure is exempted from a special group liability. First, the question whether the market can solve the liability questions for groups in an efficient way so

⁴²⁴ Posner (1976), *supra* note 405, p. 506.

⁴²⁵ For the reasons according to which creditors may be the superior risk bearers with regard to their validity for groups see below.

⁴²⁶ Kübler (1991), *supra* note 352, p. 404.

that a legally institutionalised group liability is unnecessary will be examined. Second, it will be analysed whether the economic rationale for limited liability does not apply to the situations in groups so that there should in general be a joint liability of the member companies or whether, at least for certain kinds of groups, the limited liability of the single member companies can still be justified.

a. Substitution of a Special Liability Rule for the Group by the Market

One body of opinion denies the need for a special liability rule regarding the group, as potentially arising problems can largely be solved by the market. Regarding voluntary, contractual creditors, externalisations do not appear as they are compensated for taking over additional risks. If the law changes later the distribution of risk agreed on by the parties in favour of the creditor, e.g. by piercing the corporate veil and extending liability on the shareholders, it distorts the efficient solution found by the contracting parties and burdens the risk again to the shareholders although the creditors were paid for bearing the risk so that they gain a windfall profit. Legal remedies are only necessary if the creditor was not able to appraise the risk of default accurately, therefore in cases of fraud or misrepresentation. These are cases in which the company misrepresents the nature of its activity, its ability to perform, and in general its financial condition, or the assets to which it has recourse. Included are such cases in which the company performs a riskier project afterwards than the one for which it has achieved the loan. As in these cases the creditor cannot calculate the surcharge for the additional risk, externalities appear. The law may shift risk distribution afterwards and extend liability in these cases as the market did not work correctly and did not achieve an efficient solution.⁴²⁷

Another problem for this approach is posed by involuntary creditors, especially tort creditors. For these groups the shifting of risk by limited liability is not based on a contractual agreement achieved under market conditions, they are not compensated by a surcharge for their bearing the risk of the company's default, and thus they may bear

⁴²⁷ Posner (1976), *supra* note 405, p. 520-524; Easterbrook/Fischel (1985), *supra* note 423, p.112f.; Kübler (1991), *supra* note 352, p. 416.

externalities.⁴²⁸ For a protection of these creditors, the approach provides several solutions. Piercing the corporate veil is justified for tort creditors more willingly⁴²⁹ or -predominantly- mandatory insurance for companies with limited liability is considered for tort claimants.⁴³⁰ The group of the involuntary creditors may include not only tort creditors, but also contract creditors whose transactions were too small to negotiate a surcharge for the additional risk arising from limited liability, or other groups for whom a compensation for the increased risk is normally not provided, such as employees.⁴³¹

Therefore, a special group liability is not necessary according to this opinion as the additional risk caused by the group is appraised by the creditor who is compensated ex ante for the increased risk of default. Only if the additional risk cannot be compensated by market mechanisms, because market mechanisms are distorted owing to fraud and misrepresentation for voluntary creditors or because a market transaction does not take place for involuntary creditors, is a legal protection in the form of piercing the corporate veil accepted. Thus, the decisive point for triggering off an extension of liability is not the formation of a group, but the standing of the creditors. According to this body of opinion a special group liability is viewed as not taking into account the working of limited liability in the market, and as unnecessary⁴³², whereas piercing the corporate veil for special groups of creditors is seen as justified. Regarding these considerations, this approach can be seen as being in line with recent articles which argue for an extension of liability on shareholders in favour of tort victims, and thus for doing away with the limited liability of the company in this respect.⁴³³

⁴²⁸ See for the problems of limited liability with regard to tort victims in general Leebron, "Limited Liability, Tort Victims, and Creditors", 91 *Columbia Law Review* (1991), p. 1600-1605.

⁴²⁹ See especially Kübler (1991), *supra* note , p. 407f., 416f. 418, 420; id., "Anmerkung zum TBB-Urteil", *Neue Juristische Wochenschrift* 1993, p. 1294f.

⁴³⁰ Halpern/Trebilcock/Turnbull, "An Economic Analysis of Limited Liability in Corporation Law", 30 *University of Toronto Law Journal* (1980), p. 145-147; Woodward (1985), *supra* note 334, p. 609f.; Kirchner (1985), *supra* note 43, p. 229f.

⁴³¹ See for a list of such creditors Kübler, *ibid.*, p. 408f.; Blumberg (1987), *supra* note 11, p. 76-79.

⁴³² Especially Kübler, *ibid.*, p. 422f.; Kirchner (1985), *supra* note 43, p. 229f.; Posner (1976), *supra* note 405, p. 524-526.

⁴³³ Hansmann/Kraakman, "Toward Unlimited Shareholder Liability for Corporate Torts", 100 *Yale Law Journal* (1991), p. 1879ff.; a bit more reluctant Leebron (1991), *supra* note 428, p. 1565ff., 1600-1605, 1649f.; a remark on this debate by Vagts, "Wohin mit der beschränkten Haftung der Aktionäre", *Zeitschrift für Unternehmens- und Gesellschaftsrecht* 23 (1994), p. 227ff.; rejecting the proposal Cooper Alexander, "Unlimited Shareholder Liability Through a Procedural Lense", 106 *Harvard Law Review* (1992), p. 387ff. As it is not the goal of this analysis to examine whether limited liability is justified for

It is to agree with the starting point of this approach that in general market mechanisms make the contracting parties internalise risks and avoid externalities even if as a general legal rule limited liability is chosen; however, this approach may understate the function of the law in relation to the market in this field. According to this approach, the law only provides a set of standard provisions which help to economise on transaction costs and to form a very rough guideline to determine market transactions. Providing its own solutions, the law only intervenes if the actual structural conditions for a working of market mechanisms are not given. In all other respects, the market is seen as indefinitely flexible, and the creditors as unboundedly able to determine all possible risks wherever they come from and to internalize them adequately into the contract. However, if the law is viewed only as substituting a standard form contract the function of company law will not be taken seriously; in reality the function of the legal provisions goes further.⁴³⁴ The legal provisions for the company, the installing of a separate body and organisation with a legally protected separate fund forms a starting point and a basis for the risk appraisal of the creditors; to put it in other words, the institution company as formed by company law is a datum for the market. The creditors of a company can be confident that their risk is limited and that they are protected at least by these legal provisions, which may be seen as covering "normal" risks, since for greater risks additional compensation has to be provided by market mechanisms. And they can use the institution of the company with its subtle provisions for creditor protection as a basic point in order to assess the riskiness of transactions with the company as a market partner.

However, if the legal provisions of a company do not work structurally any more, the market does not have a certain legal structure which it can take as given in order to appraise the risk of a concrete transaction. Above it was shown, that the concept of a company as conceived of by company law is in principle aligned to an independent economic activity. The concept can still be thought of as appropriate for some forms of groups, but it is structurally unable to grasp other forms of groups as

tort victims it will not be focused on this point any more.

⁴³⁴ See especially Roth (1986), *supra* note 422, p. 375-380; critical in the same direction Assmann (1992), *supra* note 244, p. 691-692.

these suspend the basic provisions of the concept of the company - the provisions securing the separate body, organisation, and fund. A legal remedy for the structural legal deficits of company law for such groups is necessary if the effects of the increase of risk for the creditors cannot be balanced by the market. The creditors would no longer be able to trust in a certain legal structure fixed by law, instead they had to assess every single group structure to see howfar it suspended the provisions for a company with regard to the provisions of the creditors and therefore increased the risk for the creditors. The calculatory assessment of the risk caused by the ineffectiveness of legal provisions seems to be impossible for the creditors, and this can already be seen in the disagreement among lawyers as to how to assess this. As the market is not able to take over the function of the law in this respect, the law must provide for legal remedies which secure the working of the market and relieve the market. This is exactly the precise function of the piercing of the corporate veil in cases in which the provisions of company law do no longer offer sufficient protection for the creditors.⁴³⁵ If the law provides for such a remedy, it makes sure that the market can take the legal structure as a starting point to assess the risks which go beyond those which are covered by the legal provisions.

b. Justification of Limited Liability for Subsidiaries in a Group

A further inquiry has to focus on whether the segregation of liability in a group by granting limited liability to a subsidiary company can still be justified by reasons of efficiency, therefore whether efficiency considerations do not require the elimination of limited liability within groups. We are dealing with a *GmbH* as an affiliated company in a group; in this company a dominant shareholder therefore exists who controls the company and performs unified management and, in addition, as a private limited company it is impossible for this company form to have its shares traded on the stock exchange.⁴³⁶

⁴³⁵ With the same result Roth, *ibid.*, p. 381f.; Lehmann, "Schranken der beschränkten Haftung", *GmbH Rundschau* 1992, p. 200ff., 205f.

⁴³⁶ As a consequence of the requirements of form in *GmbHG* § 15 it is very difficult to transfer the shares on a *GmbH*, hence this company form is not at all apt for a wide-spread ownership with shareholders who think of their shares as a pure capital investment.

Most of the advantages which scholars advance to justify limited liability and to reject unlimited liability refer to an independent public company and cannot be applied to these assumptions.⁴³⁷ All reasons concerning an efficient working of the capital market and coming from a wide-spread ownership are not valid for this constellation.⁴³⁸ Therefore, increased transaction costs for the shareholders, and increased information and monitoring costs with regard to the financial situation of their company and the other shareholders' fortunes are not relevant. Problems with split share prices in regard to the different wealth of the shareholders do not emerge. The potential unwillingness of the shareholders to allow their company to rely on debt financing as, in the end, they would not be able to control the management's borrowing for the company would not be pertinent.⁴³⁹ Increased transaction costs for the creditors as they would have to obtain information about and to monitor the financial status of the company and the financial status of their creditors in the case of unlimited liability, do not emerge - at least not to such an extent as in the public company.⁴⁴⁰ For the same reasons, prosecuting an action against the parent as the responsible shareholder because of the winding-up of the subsidiary does not cause such prohibitive transaction costs as in the case of prosecuting actions against a large number of individual shareholders.⁴⁴¹

The central point with respect to limited liability seems to be the attitude of the entrepreneurs to risk. Limited liability facilitates innovative and risky investments as entrepreneurs do not have to face the risk of losing all their assets, but only their capital invested in the company. As (at least) individuals are normally seen as risk-averse, limited liability is the way to encourage individuals to accept entrepreneurial risk.⁴⁴² At first glance, this seems to be especially important for the single trader, as

⁴³⁷ cf. the list of efficiency advantages of limited liability which do not apply for groups in general by Blumberg (1987), *supra* note 11, p. 95f. and by Easterbrook/Fischel, *The Economic Structure of Corporate Law* (1991), p. 56f.

⁴³⁸ See for considerations connected with the fungibility of shares and with the costs for the shareholders Halpern/Trebilcock/Turnbull (1980), *supra* note 430, p. 126-131, 135-138; Easterbrook/Fischel (1985), *supra* note 423, p. 94-97; Woodward (1985), *supra* note 334, p. 604-606.

⁴³⁹ See Leebron (1991), *supra* note 428, p. 1590-1594.

⁴⁴⁰ Halpern/Trebilcock/Turnbull (1980), *supra* note 430, p. 133-135.

⁴⁴¹ Halpern/Trebilcock/Turnbull (1980), *supra* note 430, p. 131-133; Woodward (1985), *supra* note 334, p. 604; Leebron (1991), *supra* note 428, p. 1610f.

⁴⁴² Posner (1976), *supra* note 405, p. 502; for a definition and explanation of risk aversion see *ibid.* note 9, 10.

he can separate his business and his private assets; thus, in case of a bankruptcy of the enterprise his private fortune is not affected. This may be even more important for the shareholder in a public company as -if he were held liable for the company's debts- all his remaining wealth would be endangered although he -as a passive investor- is not at all in control of the management which causes the risk. He would not be able to diversify his risk by holding a portfolio of different stocks and to choose an individually appropriate level of risk as all his wealth would be exposed if he were held liable for the debts of only one company.⁴⁴³

However, in a group, the situation may be seen as different. Making a parent liable for the subsidiary's debts does not result in unlimited personal liability for the parent's shareholders. Therefore, despite the liability of the parent for the subsidiary's debts, the shareholders can still diversify their risk by holding a portfolio of different stocks and, in addition, even the parent company to a certain extent may be in a position to diversify its portfolio and to thereby spread the risk.⁴⁴⁴ This view may be underlined by the fact that the parent is in control of the subsidiary. However, if we examine a small group with small companies we can see that the situation is different.⁴⁴⁵ If an individual has invested large amounts of his wealth into a single company, he will be very reluctant to form a new business in another company if the veil of the newly founded company were pierced so that the business risk of the new company also endangered the part of his fortune which is inherent in the other company. The investor in such a small company or group of companies is not able to diversify his risk, therefore he will be rather risk-averse. The *GmbH* is the company form which is typically used in this way with only a very few shareholders and often as part of a group of such small businesses - as can be seen in the cases of the *BGH*. Therefore, eliminating the limited liability of the *GmbH* as an affiliated company in a group and establishing a special group liability seems to prevent the formation of new

⁴⁴³ Easterbrook/Fischel (1985), supra note 423, p. 96f.; Leebron (1991), supra note 428, p. 1596-1605. This is one of the main reasons why creditors are superior risk bearers than shareholders as creditors' liability is always limited and they are able to diversify their risk; according to Leebron, *ibid.*, this has only very limited validity with regard to tort victims.

⁴⁴⁴ Blumberg (1987), supra note 11, p. 95, but only on the basis of its greater wealth and with the disadvantages which the development of a conglomerate group carries with it.

⁴⁴⁵ cf. Leebron (1991), supra note 428, p. 1627-1630; Posner (1976), supra note 405, p. 512.

ventures in this constellation. This argument is not excluded, either, by the fact that such a shareholder is normally in control of the company: the business risk in a market economy is not fully controllable, it may even be increased by state regulation and other state interventions in the economy.⁴⁴⁶ In addition, even in a larger group with an affiliated *GmbH* risk-aversion may be at stake. As the shareholders of the parent can normally diversify their risk they expect the company of which they own shares not to be risk-averse, but more risk neutral.⁴⁴⁷ However, the decisions about new investments are taken by the company's directors as ownership and management are separated. The managers are unable to diversify their human capital⁴⁴⁸, therefore their decisions will be determined by risk-aversion. They will not only be risk-averse regarding the winding-up of their company, but a severe loss in one part of the enterprise affecting other parts may well endanger their jobs. Hence, the managers of a large company will also be reluctant to start a new innovative business whose risk may affect the other parts of the business. By setting up a subsidiary for the new venture with limited liability in the form of a *GmbH*, this risk-aversion can be overcome.⁴⁴⁹

Other efficiency advantages of limited liability may be found in the structure of the group. The limited liability of the subsidiaries may support the above-described decentralised structure as the parent is not charged with the subsidiary's whole business risk.⁴⁵⁰ Furthermore, the selling of a subsidiary causes fewer transaction costs if a new ordering of the liability between the contracting parties is not necessary.⁴⁵¹ Moreover, the information costs for the creditors may be lower, since if their debtor is endowed with limited liability, they have only to assess the financial situation of the concrete subsidiary (and the risk of financial abuses within the group), and in the case of an extension of liability they have to assess the financial situation in the whole group.⁴⁵²

⁴⁴⁶ See Roth (1986), *supra* note 422, p. 373; Lehmann (1986), *supra* note 33, p. 356.

⁴⁴⁷ See Posner (1976), *supra* note 405, p. 502, note 9; Easterbrook/Fischel (1991), *supra* note 437, p. 29.

⁴⁴⁸ Easterbrook/Fischel (1985), *supra* note 423, p. 107f.

⁴⁴⁹ cf. also the thorough analysis by Debus (1990), *supra* note 159, p. 149-158.

⁴⁵⁰ Debus, *ibid.*, p. 166-172; however, it seems to be doubtful whether limited liability is a necessary condition of the decentralised structure, see above B III 3 b footnote 241.

⁴⁵¹ Debus, *ibid.*, 172-177.

⁴⁵² Debus, *ibid.*, p. 140-148.

A further argument for making available limited liability for companies in groups can be seen in comparison to independent companies. If subsidiaries are appropriately endowed with equity capital and assume the same role as independent companies there seems to be no reason to give unaffiliated companies an advantage by necessarily establishing a joint group liability.⁴⁵³ If limited liability represents a decisive competitive advantage which is also relevant for groups this could in the end lead to a disintegration of industry although the size and integration of the enterprise lead to efficiency gains which could then no longer be achieved.⁴⁵⁴

The two main arguments for the justification of limited liability in a group, the argument focusing on risk-aversion and the comparative argument, make also the limits for the approval of limited liability in groups apparent. The comparative argument is only valid if the company arrangement does not increase the risk for creditors over the one they would have to bear if the companies were organised as separate ventures; thus, only if the protective provisions of company law also grasp the subsidiary. The risk-aversion argument can only be applied if the subsidiary has at the end to bear the business risk caused by the market.⁴⁵⁵ The subsidiary only bears such a risk if it is aligned to the market and is responsible for its activity in the market; the risk-bearing has to refer to the company as a unit as well as to its directors. The company only bears a risk if it is adequately capitalized, otherwise all the risk is shifted to the creditors and externalized. The directors only bear the risk if they have to decide about the activity of the subsidiary in the market and if their personal status depends on the company's success in the market. Therefore, a precondition for such a risk-bearing of the company is the granting of a certain degree of autonomy to their directors insofar as it is necessary for an activity in the concrete market under their own responsibility.

However, if the subsidiary is not set up as a separate unit in the market, and is thus not endowed with an equity capital appropriate for its activity in the market, and

⁴⁵³ Easterbrook/Fischel (1985), *supra* note 423, p. 111; Roth (1986), *supra* note 422, p. 373.

⁴⁵⁴ See for a critical analysis Leebron (1991), *supra* note 428, p. 1615-1619.

⁴⁵⁵ See for exposing the company to the risk in the market as the necessary minimum for granting the privilege of limited liability in a market economy and the implications of this principle Lehmann (1986), *supra* note 33, p. 356, 362f.

if its directors are not granted the degree of autonomy needed for an activity in the market under its own responsibility, the parent uses the limitation of the subsidiary's liability only to externalize risks and not to create a body which is designed and able to bear the risk in the market. In this case, the market no longer controls the company and eliminates it as a market participant if it is not successful in the market but the subsidiary is a mere instrument of the parent, and in the case of a winding-up of the subsidiary the parent only loses the inappropriate capital invested in the subsidiary and the parent's directors who led the subsidiary into the winding-up proceedings are not affected personally by this.⁴⁵⁶ Such a structure therefore forms an abuse of the institution limited liability, an extension of the liability on the parent is justified.⁴⁵⁷

If, on the other hand, the subsidiaries are given a profit centre standing and their directors can decide more or less autonomously with regard to their market, the structure seems to be compatible with these conditions: the company as a profit centre is responsible for its success in the market, the director(s) are personally responsible for its success and are judged accordingly. Thereby the moral hazard problem caused by limited liability is also limited.⁴⁵⁸ If directors personally and the subsidiary itself have to bear the consequences of a failure in the market, they will avoid excessive risk-taking. Therefore a profit centre structure shifts the responsibilities to the points where they have to be in order to guarantee the working of the legal construction of a company endowed with limited liability in the market.⁴⁵⁹ Furthermore, a certain correspondence of interests is secured by this structure. Since the subsidiary and its directors have a self-interest of survival in the market, the interests of the creditors are also secured against an unlimited neglecting of their interest.⁴⁶⁰ The limited liability of a subsidiary of this type can also be held in comparison to the liability of a natural

⁴⁵⁶ Lehmann, *ibid.*, p. 367f..

⁴⁵⁷ Lehmann *ibid.*; Roth (1986), *supra* note 422, p. 381; Easterbrook/Fischel (1985), *supra* note 423, p. 111.

⁴⁵⁸ See for the moral hazard problem with regard to parent subsidiary relations Easterbrook/Fischel *ibid.*; in general Halpern/Trebilcock/Turnbull (1980), *supra* note 430, p. 140f.

⁴⁵⁹ In this way also Teubner's demand for a correspondence of the point where the decisions are taken in a group and the point on which the law connects responsibility for actions seems to be at least largely complied with, see Teubner, "Die 'Politik des Gesetzes' im Recht der Konzernhaftung", *Festschrift für Steindorff* (1990), p. 261ff.

⁴⁶⁰ cf. Roth (1986), *supra* note 422, p. 381.

person. The creditors of the natural person are secured by its fortune -which can change very rapidly- and by a certain correspondence of interests as it is assumed that the natural person does not want to institute bankruptcy proceedings. In a certain parallelism the creditors of a company are secured by the guarantee fund of the company and by a certain correspondence between the interests of the managers and the owners of the company;⁴⁶¹ these precautions are also valid for a group with a profit centre structure. As the liability of a natural person is also limited to its wealth, this concept of relativized liability is transformed into limited liability for a company: the subsidiary as a profit centre in the form of a *GmbH* complies with the fundamental points of this concept.

D. Conclusions

The efficient group structure with a minimum of unified management has been developed as a decentralised, divisional structure with subsidiaries as profit centres whose managements take over the operative affairs and are responsible for their concrete markets in a fairly autonomous way, while the group management performs strategic management, and controls and coordinates the subsidiaries. Coordinating the subsidiaries with regard to the goals of the group as a whole, the group management achieves the advantages of the internal direction of the affiliated companies over market coordination; these advantages are economies of scale and scope, economies on transaction costs, and a better exchange of information between the companies. In general, the relations between the companies are governed by the market principle, the group management aligns the group members only to the strategic goals of the group and otherwise intervenes as little as possible in the subsidiaries' management. Direct hierarchical management means are substituted by more indirect devices, such as the performing of financial management, personnel management by appointing the subsidiaries' directors, establishing a comprehensive accounting and auditing procedure, and other coordination instruments.

⁴⁶¹ See for this functional comparison Roth, *ibid.*, p. 378f.; for the interests in the company with regard to the creditors see C IV 2 c.

The legal structure of a *GmbH* as an affiliated company does not prevent the introduction of an efficient economic organisation of this type. This, of course, is valid if the affiliation of a *GmbH* is based on a control contract, but is also true for a *GmbH* as an affiliated company in a de facto group. In the economic organisation the *GmbH* is seen as a separate body to whom separate assets and entrepreneurial tasks are attributed. The subsidiary is aligned to the market and keeps a self-interest which is directed to maximizing profits. However, as the company is no longer independent it pursues the self-interest only within the framework of the group interest, but the interventions of the group management with respect to the strategic direction of the company do not exceed the very wide legal limits which are set for shareholder influence by the *GmbH-Gesetz*. Therefore, the standing of a profit centre in the economic organisation keeps the legal structure of the *GmbH* as a legal person.

In a *GmbH* as an affiliated company with this kind of economic organisation, the protection of the creditors by the devices of common company law is still sufficient. The protective measures provided by organisational law and by these provisions which directly secure the separate fund for the creditors function in an economic environment of this type. However, this economic organisation also forms the limit beyond which the usual devices for the creditor protection no longer work. Therefore, it can be used to show up the line beyond which assuming liability for the parent is appropriate. Thus, the recent *BGH* jurisdiction for extending the liability on the parent of an affiliated *GmbH* can be justified and, above all, the criteria which trigger off the extension can be assessed and concretized. As criterion for the extension of liability not mainly the comprehensive and permanent management of the parent is to choose, but it is to focus on a serious damage of the subsidiary company's interest. Such damage to the subsidiary's interest can be defined according to the above-described economic organisation. The drawing of such a line within which limited liability can be accepted for affiliated *GmbHs* is also compatible with efficiency considerations regarding limited liability. The extension of liability on the parent if the organisation of the group as described above is not maintained, belongs to the functions of the law in this field; market mechanisms cannot completely replace this function of the law. On the other hand, considerations about the efficiency of limited liability do not require the

elimination of the limited liability of subsidiary companies within groups as limited liability can also work in groups, as a positive principle which is socially valuable and leads to an efficient allocation of resources.

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